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TAX REFORM PROPOSALS—XIX

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

JULY 25, 1985

INCOME TAX DEDUCTIONS OF STATE AND LOCAL GOVERNMENTS

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IMPACT OF THE TAX REFORM PROPOSAL ON STATE AND LOCAL GOVERNMENTS

THURSDAY, JULY 25, 1985

U.S. Senate,
Committee on Finance,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m. in room SD-215, Dirksen Senate Office Building, Hon. Robert Packwood (chairman) presiding.

Present: Senators Packwood, Heinz, Durenberger, Symms, Grassley, Bentsen, Moynihan, and Bradley.

[The prepared statement of Senator Durenberger follows:]

WRITTEN STATEMENT OF

SENATOR DAVE DURENBERGER

ON

STATE AND LOCAL TAX DEDUCTIBILITY

BEFORE THE COMMITTEE ON FINANCE
JULY 25, 1985

Dear Mr. Chairman:

I appreciate this opportunity to address the Committee on this important issue--the federal income tax deduction for state and local taxes. This deduction has been a provision of the Internal Revenue Code since the creation of the federal income tax in 1913. The President's tax reform plan would eliminate this deduction.

The Administration considers this deduction to be an unfair subsidy to the rich in high-tax states with a penchant for big government. This rhetoric ignores the fact that the state and local tax deduction is part of a much larger system, called fiscal federalism.

In reality, national, state, and local taxes are combined in a Federal Tax System. And it is the federal tax system--not just national taxes--that is the engine for a successful domestic economy. So, if we are going to tinker with that engine, we had better know how its parts fit together; or we may not get it started again.

I speak to you today as the Chairman of the Senate Subcommittee on Intergovernmental Relations. As Chairman, I participated in the New Federalism debates in 1982. At that time, it was clear to those of us in the trenches that state and local tax deductibility is one of a number of ways in which the national government helps states and local governments to handle their own responsibilities.

The New Federalism initiative may have died, but de facto New Federalism is alive and well. Over the past four years, we have thrust upon state and local governments more and more responsibilities with fewer and fewer national dollars to go with them. And, undoubtedly, we shall continue to do so.

It is only in this Federalism context that we are able to see state and local tax deductibility clearly. Deductibility allows states to raise and keep their own revenues. And it rewards them for handling their own responsibilities.

My subcommittee examined this issue at a hearing in June, and we received testimony from many groups and individuals--some of whom are here today. I'd like to read a few comments from them:

> "Federal budget cuts, and the elimination or reduction of certain federal programs have put additional burdens on state and local governments throughout the country. Removal of the federal deduction for state and local taxes would have a serious impact on the ability of these governments to raise the funds needed to meet their increasing obligations."
>
> "The proposed elimination of deductibility threatens to weaken our federation of states, which is the foundation of our nation. Factors such as state sovereignty, fiscal federalism, equity, and national security do not easily lend themselves to economic modeling and standardized indices. In today's uncertain time, it would be foolhardy to abandon these principles in pursuit of new goals which are framed more by rhetoric than careful and considered analysis."

These are strong words . . . expressing powerful sentiments. You're probably thinking they were spoken by Governor Mario Cuomo or Senator D'Amato or Senator Moynihan. After all, they are all from New York, the highest tax state in the country, and citizens of New York have the most to lose if the deduction is eliminated. But it wasn't Governor Cuomo nor Alfonse D'Amato nor Pat Moynihan nor anyone from a high-tax state. These are the concerns and protestations of the Governors of Alaska and Wyoming--the two states that would be the biggest winners if the deduction were eliminated. They know that the issue of deductibility is more than an issue of winners and losers, and it must be viewed in the broader context of our federal system.

Our national, state, and local governments are joined in a single system of government, sharing responsibilities and resources. And while some states might not benefit as much from deductibility, they receive the benefits of our intergovernmental system through grants to state and local governments, defense contracts and procurement, and direct payments to individuals. For example, Governor Sheffield of Alaska knows that his state received the fourth highest per capita federal expenditure for defense contracts in 1983, a whopping $1,783 compared to the national average of $778 and a lowly $445 in Minnesota.

The Governor of Mississippi also wrote to me in support of the deduction, even though his is a low-tax state. His citizens might not receive much benefit from the deduction, but for every $1 that Mississippi pays in federal taxes, Mississippians receive $1.67 back in federal spending. On the other hand, Minnesotans receive less than they put in: only 87 cents, resulting in a ranking of 42 for Minnesota.

Now, I'm not suggesting that each state should receive the same level of federal spending. What I am saying is that states which levy high tax rates so they can take care of many of their problems without federal aid--states like Minnesota--should not be penalized. I think the Governors of Mississippi and Wyoming realize that while they might be low on the totem pole for some things, they are high for others. And for them to point the finger at high-tax states would be like the pot calling the kettle black.

By repealing the deduction, the Treasury Department is treating state and local tax deductions as though they were identical with tax subsidies for three-martini business lunches. In fact, under the Administration's proposal, those lunches fare better: That deduction is reduced but not eliminated.

The Administration says its plan is simple and fair. Well, repealing the deduction for state and local taxes is certainly a simple way to keep the plan revenue neutral. But that doesn't make it fair.

I believe the tax reform plan is grossly unfair to state and local governments. Consider these statistics: The estimated federal government revenue loss for tax expenditures which benefit individuals is $293 billion for Fiscal Year 1986. Deductibility of state and local taxes represents $33.2 billion--about 11 percent of the total. Yet, deductibility represents 67 percent of the Administration's proposed modifications of tax expenditures that would lower tax rates. I don't call this fair.

I will just mention briefly the reasons I believe the deduction of state and local taxes is critical for our intergovernmental system. First, the deduction prevents the national government from capturing all of the tax base and helps to preserve some portion of the base for state and local revenue sharing. Without the deduction, state and local governments will face increased voter resistance to raising taxes to finance needed expenditures. The Congressional Research Service estimates that revenues from state and local taxes paid by itemizers could decrease by up to 13 percent if deductibility is repealed. And this decrease would mean a decline in state and local spending, during a time when we are already asking states and local governments to assume more responsibilities.

The deduction also helps to cushion the harmful tax competition among states by reducing the effect of fiscal disparities among them. There are several factors, other than a preference for big government, which can cause differences in tax rates. For instance, large urban areas that have a higher than average percentage of the poor must impose a heavier burden on the non-poor so that ordinary public services--education, police, roads--are provided at adequate levels. Without the deduction, high-income taxpayers face an incentive to move to lower tax jurisdictions, leaving behind a depleted tax base which cannot support the low-income population.

Conversely, low-tax states don't necessarily have a preference for less government but might be able to generate revenue from other sources, such as natural resources, tourism, manufacturing--sources which enable them to export their tax burdens to other states.

Deductibility doesn't eliminate these differences, but it does help to cushion them. For example, under the current tax system with the deduction for state and local taxes, a family of two, with an income of $30,000 in Moorhead, Minnesota, pays a total federal, state, and local tax bill of $4,390. That same family, in Fargo, North Dakota, pays $3,448, a difference of $942. If the deduction were eliminated, both families would experience an increase in their tax liabilities, but the increase would be greater in Moorhead. The difference between the tax bills in the two jurisdictions would now be $1141, an increase of 21 percent because of the loss of deductibility.

So, I believe that reducing these disparities is itself a matter of fairness: Individuals with the same income and receiving roughly equivalent services should not face widely disparate tax bills.

Finally, because the actual dollar amount of the deduction is proportionally greater as one moves up the income scale, the deduction gives states an incentive to rely less on regressive taxes and to increase their reliance on progressive income taxes.

While high-income individuals benefit from the deduction, it is also important to the middle class. One half of all households with incomes between $20,000 and $25,000, and almost two thirds of all households with incomes between $25,000 and $30,000, utilize the deduction. Thus, the middle class also benefits directly from the deduction; and low-income individuals receive in direct benefits from the higher service levels that higher income individuals are willing to support.

I am willing to concede that targeted grants might be a more efficient means of assistance to state and local governments; but nobody is talking about replacing deductibility with grants. In fact, while we are attacking states and local governments on the tax side, the budget committee are wielding the ax on the expenditure side--and they are doing it without the proddings of David Stockman.

Optimally, then, I would prefer that the deduction for state and local taxes remain unchanged. It is one of the cornerstones of a healthy intergovernmental system. However, I want lower tax rates just as much as the next person and will agree that state and local governments should be called upon to do their part. But this does not mean total elimination of the deduction.

In searching for an alternative to outright repeal, some have advocated selective repeal of deductibility for particular taxes. For example, the Bradley-Gephardt proposal repeals the deduction for state and local sales and personal property taxes. Kemp-Kasten eliminates the deduction for state and local income, sales, and personal property. These approaches are just as problematic as total elimination. They would have the federal government intrude into state and local choices about which taxes they should utilize, creating a bias for state and local policymakers to increase reliance on those taxes which remain deductible. Another problem with selective repeal is that the effects would be distributed unevenly among taxpayers in different states. For example, those states which did not levy sales taxes would not be affected. The additional revenues would only come from those states that rely on the particular tax.

Now, I know compromise is never easy; and, as always, those who are willing to pursue it are hard to find. So, I was happy to learn that at the House Ways and Means Committee hearing last week, some Members were looking for a compromise.

Last January, I introduced a compromise that is simple, is fair to all states, and contributes its share to rate reduction. This proposal is attracting bipartisan support both inside and outside of Congress. In the House, a companion bill was introduced by Representative Cecil Heftel.

Under my proposal, S. 315, each itemizing taxpayer could pool his or her state and local taxes and deduct that amount exceeding one percent of adjusted gross income. My proposal has several advantages. First, itemizers in every state will remain eligible for the deduction, while differences in state tax systems are respected. In 1980, for example, the average taxpayer taking the state and local tax deduction claimed an amount equal to six percent of adjusted gross income, with the average deduction ranging from three percent of AGI in Wyoming to 12.6 percent of AGI in New York. So, with the one-percent floor, two thirds of the average itemizer's tax payments in the state with the lowest overall tax burden--Wyoming--remains deductible; and no state suffers an inordinate loss in deductions available to its taxpayers.

My plan also increases the progressiveness of the state and local tax deduction. While all itemizers would continue to benefit substantially from the state and local tax deduction, taxpayers with higher incomes and in higher marginal tax brackets would lose a somewhat larger share of their state and local deduction than would low- and middle-income taxpayers.

The Treasury estimates that the cost of a one-percent floor under the President's tax plan--in terms of federal revenues foregone--would be $23 billion in FY 1987, $21 billion in FY 1988, $23 billion in FY 1989, and $25 billion in FY 1990. These figures represent a reduction of approximately 40 percent compared to the cost of full deductibility in the current tax code. Thus, the one-percent floor would represent a fair and substantial contribution to the lowering of overall tax rates.

The one-percent AGI floor also has a strong theoretical rationale. The one-percent floor assumes that taxpayers would be willing, in a free market, to pay at least one percent of their adjusted gross income for the state and local services they consume. Therefore, a deduction need not be allowed for this portion, which can be viewed as payment for direct services received.

Finally, because the negative effects on individual taxpayers is relatively small with the one-percent AGI floor, state and local taxes and services are not expected to decline.

For some time, it has been clear to me that the lines in this debate about deductibility are drawn sharply.

There are those who view deductibility merely as revenue foregone. And they are wrong.

There are those who favor sweeping changes without respecting differences among existing state revenue systems. And they are wrong.

Finally, there are those who would save the deduction at all costs. But, if we value tax reform--and we should--that might not be possible.

The deductibility of state and local taxes threatens to be the major stumbling block to achieving tax reform. I offer my proposal in the spirit of compromise so that we may move closer to a goal which we all share--an efficient and fair tax system.

The **Chairman**. The hearing will come to order, please.

Today, we are hearing principally about the issue of the deductibility of State and local taxes and whether or not if we adopt a tax reform bill that deduction should continue or be eliminated or modified. In addition, some witnesses have some comments on the rehabilitation tax credit and other facets of the tax reform bill, but far and away the principal focus of the testimony this morning is that of the deduction of State and local taxes.

Our first witness is an old, old friend of this committee and of mine personally, Senator Jack Javits who served in this body for a quarter of a century without peer and with distinction that any of us by one-tenth would be lucky to match. I had the good fortune to go to NYU Law School in the mid-1950's and even had occasion to observe Jack Javits when he was attorney general of that State before he came to the Senate. And I can say that in my judgment I have not served with another person in this Senate that is as capable or competent or as broad gauged as he is. And we are delighted to have him back with us today.

Senator **Javits**. Thank you very much.

Senator **Bentsen**. I have to add mine to that. Jack Javits was an inspiration when he was here and he's an inspiration now. And I'm just delighted to be with him this morning.

Senator **Moynihan**. Lest silence be misconstrued, may I welcome my revered senior colleague, as I called him when he was here and as I regard him still. And may I express the hope that the chairman's admiration for the qualities of the man will lead to special consideration for his point of view. [Laughter.]

The **Chairman**. Jack, go right ahead.

STATEMENT OF HON. JACOB K. JAVITS, FORMER U.S. SENATOR, STATE OF NEW YORK

Senator **Javits**. Mr. Chairman, first, I am deeply moved to appear before this committee in this room. And I express my deep appreciation to you and to Senators Bentsen and Moynihan who are here this morning. And I have no notion about the fact that your deeply gratifying opinion of me will influence your judgment. Were I sitting where you are, it would not influence mine.

I am deeply grateful to Senator Durenberger for allowing me to precede him this morning, and for doing me the honor of being here to hear me.

It may seem a little unusual for me to be appearing on an issue of States rights considering the fact that the years in the Senate I fought to assert the Federal authority where the States were failing in their responsibilities. But the key to the issue before you on the deductibility of State and local taxes is whether or not the federalism upon which our government is organized requires that we assist rather than impede the States when they try to discharge their responsibilities.

Second, whether comity between the States requires burden sharing. And just as we, in the so-called high tax States, have heavy responsibilities in respect of poverty and law enforcement and discrimination and education and we contributed enormously. And Senator Moynihan has been a great champion in that regard to help other States without begrudging it when they needed dams and bridges and irrigation and farm price support, and a dozen other things.

Two good examples are the fact that the Medicaid and aid for dependent children formulai are slanted toward the so-called low-tax States. Now the President's tax plan lost something on its way to the Congress. Between Treasury and the administration, a minimum of $240 billion went out the window for the 5-year period that is the base of the argument for this plan: One hundred and seventy-four billion in extra depreciation; $31.5 billion in the taxability of financial institutions; and some $40 billion in oil drilling allowances.

Now nonetheless the administration would have us believe that the roughly $147 billion over 5 years represented by this nondeductibility is absolutely essential to fuel the tax revision plan. Now the figures I have given do not include the reduction in the capital gains tax, which Wall Street itself, from whence I come, cannot understand what that is all about. It's pretty good right now. And Martin Feldstein the other day in analyzing the drastic increase in the personal exemptions pointed out that if you confine that increase to those reporting under $30,000 in income you would gain $20 billion a year or $100 billion in 5 years for the tax take.

Now that makes pretty much a shambles of this argument that you got to have the money to fuel the tax plan.

And one other point. This was—tax revision to close loopholes in the taxes, special interests. Since when are 16 States, vis-a-vis Treasury figures—I include Illinois—with 108 million people a special interest and yet that's whom you are going to punish by nondeductibility.

Now this deductibility has been incorporated in the law since the beginning of the income tax. And as you heard a dozen times, it was even the rule in the Civil War when we had an income tax. And that represented the kind of a compact between the State and the Federal Government to which we are accustomed in this country. And it's proposed that it be cut down immediately as of January 1, 1986. That's one great way to treat your fellow Americans. Now who is going to get hurt? The kids are going to get hurt, and the homeowners are going to get hurt.

Pat Moynihan has given us some good figures on education, which show a dimunition of a minimum of 11 percent and maximum of 20 percent if you eliminate the deductibility considering the support from taxes of education at the local level. And I think the figures show that at a minimum it will cost a little over $200 a pupil per year, a maximum of about $1,000 per pupil per year, and an average of about $600. And I think we all agree on the critical importance of education support.

And that raises one other question. When the income tax was passed, the understanding was that the Federal Government had to get its revenue there, leaving the property tax to the States and localities. And if you deny the deductibility, you destroy this balance at one fell swoop.

And one other point. When I was here fighting the battles avoid New York City's bankruptcy with Moynihan and Keating and many others who helped us, it began to be realized that if New

York went, big cities throughout the Nation would be deeply hurt and everybody realized that they had a New York in their State, even if it might be called Omaha or St. Louis or New Orleans or Cedar Rapids. And it's the same here. This isn't a New York issue. The kids in every State will be hurt if education is diminished. And the people who own homes in every State will be hurt if they can't deduct their property taxes. And the value of homes will be depreciated, and that includes millions of homeowners.

In short, gentlemen, notwithstanding deals with other economic interests, justified or not, this nondeductibility will punish great groups of Americans and will disturb the balance which has been established between the Federal and State governments; will cause people, yes, to vote with their feet, to pick up and move from cities to suburbs, or to another State, and from so-called high-tax to low-tax States, all in the name of tax revision.

In this country, we have helped each other and we need it now. We need that help in the States that have heavy responsibilities and to carry them. And that's why I'm here today.

Thank you, Mr. Chairman.

The **Chairman**. Senator, thank you very, very much.

[The prepared written statement of Senator Javits follows:]

TESTIMONY OF JACOB K. JAVITS
BEFORE THE COMMITTEE ON
FINANCE
U.S. SENATE

ON JULY 25, 1985 at 9:30 A.M.

DEDUCTIBILITY OF STATE AND LOCAL TAXES

The greatest controversy over the President's tax revision plan is now concentrated on the effort to make non-deductibility from Federal income tax local and state taxes paid. This effort runs counter to the U.S. system of Federalism to comity between the states to the equal treatment of their citizens. It will hurt cities, towns and counties as well as states. It discriminates against homeowners and will be especially harmful to school children.

It is now clear that the only reason advanced for this proposition is to put it baldly that the revenue involved is needed to fuel the President's tax revision plan. The amount involved is generally referred to according to the Administration's book on the subject as $33.8 billion per annum an aggregate of $148.9 billion over five years (actually $26 billion using the lower tax rates of the President's plan an aggregate of actually $129.2 billion over the same five year period).

Even this proposition is unsustainable when we take into account the sums of Federal income taxes taken out of the President's plan by accommodations with other economic interests in amounts far exceeding what is involved in state and local tax deductibility. I estimate the amounts which disappeared from the revenues to be available under the Administration plan under the same five year basis to be $240.5 billion broken down as follows: depreciation 174.2; financial institutions 31.5; international taxes 0.5; oil and gas drilling 34.8.

These figures do not include a reduction of the federal capital gains tax from the present 20% to 17.5%; and exclude also the ballooning of the depreciation figure when extended for 10 years after the five year estimate according to the calculations of the Congressional Budget Office which sees serious revenue losses at a time of extremely heavy federal deficits in this projection.

The Administration started out by claiming that the non-deductibility was justified because low tax states were subsidizing high tax states. It based this claim on the proposition that non-deductibility punishes only the people of 15 states and the District of Columbia whose per capita tax saving from such tax deductions under current law is above the national average (but I include Illinois whose tax savings per capita are just about at the U.S. average and which is tenth in the rank of income per capita in the states) making it 16 states. Even if the impact were limited to these states, they have a population of 108 million and from their people is derived 50% of the total personal Federal income tax paid.

The Administration's claim that deductibility of state and local taxes is to be denied because the low tax states subsidize the high tax states is erroneous and unfair. Also, it is the tax revenues from these same high tax states that have for all the years of the income tax financed the expansion of the U.S., bringing power and telephones to the Northwest, irrigation to the Southwest, the TVA to the South and many other benefits to many other so-called low tax states in the nation. The formulas for the distribution of medicaid and AFDC and the benefits of farm price legislation are heavily weighted in favor of these low tax states and the people of the high tax states have paid billions in federal taxes more than they received from the Federal government to sustain these expenditures.

It is claimed that only itemizers are hurt by the non-deductibility of state and local taxes. But what is not stated is that itemizers pay 69.9% of the income taxes paid by the people of the U.S. and that the popularly advertised figure that only 1/3 of the taxpayers are itemizers fails to take account of joint returns which include two taxpayers and raises this figure to over 40%. Nor is it advertised that the non-deductibility as far as itemizers are concerned hits hardest at the middle class. While the figures show as would be expected (because the Federal income tax is progressive) that the greatest amount of money (74%) of what is deducted for state and local taxes paid goes to people with incomes over $30,000 per year the fact is that the deduction is taken by 87% of the taxpayers in the income bracket of $50,000 per annum and less and 51% by itemizing taxpayers in the income bracket of $30,000 per annum and less. There is also the fact pointed out by Senator Durenberger of this committee that the Administration tax revision plan continues to allow deductibility of interest on mortgages and charitable contributions. These deductions of course should be continued but the inconsistency is sharp and poignant as they benefit the same people as the deduction of state and local taxes and there seems to be no ethical reason to discriminate.

The deductibility of state and local taxes, namely property taxes including school taxes, income taxes, and sales taxes has been a fundamental principle of the Federal income tax for 72 years since it was first adopted by Constitutional Amendment in 1913. Indeed, the first income tax enacted during the Civil War over 120 years ago allowed such deductibility. It has been an accepted and essential Constitutional principle as an underlying basis for the comity between the states and the Federal government.

It is extraordinary that this Administration would breach this cardinal principle at the very time when the new Federalism preached by the President proposes additional burdens on local governmental initiative in education, health, housing, crime control and places for the homeless and under-privileged and a whole list of other services essential to the common good. The states under the system of Federalism were to be the laboratories for initiation and differentiation in public policy. Here at one fell swoop the means for this purpose are to be sharply curtailed at the source.

The question raised here is whether the Administration is seeking to dictate to the states their public policy on these vital issues of education, health, housing, crime control, children, the homeless, welfare and many other services by cutting down on the resources available to them. Let us remember that it is the states which created the U.S. just as they created their own municipalities, not the other way around.

Let us remember too, that Federalism demands of the states that they discharge their responsibilities and this implies the continuance of the requisite means to do so.

The Civil Rights laws, in the shaping of which I took an especially active part, emphasized the principle which lies at the base of Federalism. The cooperative spirit of our people with their fellow Americans who may be disadvantaged has always in modern times been one of the distinguishing features of our national life. Non-deductibility turns this national character and the Federal system itself on its head by penalizing those very states which are doing the most to give every citizen an equal career starting line. The Civil Rights laws of the 60's setting a national pattern of non-discrimination have been implemented by states in just this way.

In fact, non-deductibility of state and local taxes does not just affect the so-called high tax states. Every study, including those done by Treasury, shows that it will probably result in a reduction in services in every state. The irony is that it may be the poorer states that are now striving to upgrade their public services, as Arkansas has just done with public education, that will find it harder to raise the necessary revenues locally and will be trapped at an inferior service level.

Eliminating deductibility will create problems of taxpayer migration from city to city and from metropolitan areas to suburbs. This would be true even in low-tax states as well; and older cities would suffer very badly compared to suburbs in their metropolitan areas. Similarly, loss of deductibility means greater regional competition for higher income people. Today, a couple in Portland, Oregon, earning $100,000 annually, pays in taxes about $3,800 more than the same couple in Seattle, Washington. Eliminating deductibility will double this difference to over $7,500 giving itemizers a serious incentive to leave where they are. To keep higher income taxpayers, cities and states will be forced to cut their taxes and therefore services. This could hurt people at the lower income levels far more than they would gain from tax revision.

This issue of non-deductibility of state and local taxes is a national issue, not a sectional one. It will be especially harmful to homeowners and to the elderly and estimated 3.4 million who are homeowners for whom the deduction state and local taxes is most often the largest deduction and who pay the same property taxes as anyone else. Every homeowner in America -- in all 50 states -- whether or not they itemize deductions will see the value of their home ownership drop because of this one provision.

The 39 million children receiving elementary and secondary education in our public schools will probably be the hardest hit by non-deductibility. It is estimated that the total tax expenditure state and local for elementary and secondary education aggregate over $120 billion per year; that deductibility from Federal taxation of this aggregate is about $14 billion dollars for education purposes per year and represents more than 40% of the total amount deducted from federal income tax for state and local taxes. Estimates of the cut in state and local taxes devoted to education which will result from the pressure of declaring state and local taxes non-deductible from the federal income tax vary from $231 to $1,069 per pupil per annum, representing at the best in 11% dimunition and at the worst a 20% diminution. Senator Moynihan, a member of the finance committee, has estimated an average loss of $606 per pupil per annum as the likely result of non-deductibility. At a time when education and its short-comings are critical to our national interest, this is bound to be a heavy blow to what is best for our country.

Finally, what about the financial ability of states and localities to raise money through bond issues for development and infrastructure now so urgently needed. The ratings of Standard and Poor and other such agencies will certainly depend heavily on whether there is continuing deductibility of state and local taxes to back up these bonds.

Where is the fairness in such a tax revision plan?

Already the Administration has made deals with special interests to punch big holes in the tax revision plan shown in the differences between Treasury I and the instant plan. Tax revision which discriminates against large groups of Americans who are helping to discharge proper governmental responsibilities in their states and localities and which would encourage movement out of their states and localities by those best able to pay taxes, while deals are made with specific economic interests to punch big holes in revision without regard to the inequities must be considered neither fairness nor simplification nor conducive to growth.

The CHAIRMAN. We can take Senator Durenberger, and then I think we might have some questions for both of you.

David?

Senator DURENBERGER. Mr. Chairman, thank you. And the eloquence and comprehensive nature of that statement will cause me to abbreviate my own comments substantially.

I, Mr. Chairman, do not have any fiscal skeletons in my closet. We all know I represent a high-tax State. Minnesota taxpayers stand to lose significantly if the State and local deduction is eliminated. But I'm not here to address you as a Senator from Minnesota. I'm here to speak as chairman of the Subcommittee on Intergovernmental Relations, a position that has convinced me over the past 4½ years that the State and local tax deduction is too important a part of the intergovernmental system to lose.

The administration's rhetoric attacks State and local tax deductibility as the single biggest loophole in the Tax Code. No more, they say, than a subsidy to the rich in high-tax States with a penchant for big government.

But is that really what State and local tax deductibility is about? I think not.

If we think about State and local tax deductibility only as a loophole to be closed—a quick and easy way to lower individual rates and still keep the tax reform plan revenue neutral—we will miss the forest for the trees.

State and local tax deductibility, as Senator Javits has pointed out to us this morning, is part of a much larger system called "fiscal federalism." The balanced operation of Federal, State, and local tax systems—not just Federal taxes—is the engine for a successful domestic economy.

As the chairman of the Senate Subcommittee on Intergovernmental Relations, I participated in the new federalism debates in 1982. At that time, we discussed ways to return more authority to the States. It was clear to those of us in the trenches that State and local tax deductibility is one of a number of ways in which the National Government helps those governments handle their responsibilities.

In June of this year, my subcommittee examined the deductibility issue again. And I would like to read a comment from one of the witnesses: "The proposed elimination of deductibility threatens to weaken our federation of States which is the foundation of our Nation. Factors such as State sovereignty, fiscal federalism, and equity do not easily lend themselves to economic modeling and standard indices. It would be foolhardy to abandon these principles in pursuit of new goals which are framed more by rhetoric than by careful and considered analysis."

Those are strong words, and you probably think they are the words of Governor Cuomo or our colleagues Pat Moynihan or Alfonse D'Amato. But it was not Mario Cuomo. It was not Pat Moynihan. It was not Alfonse D'Amato. In fact, it wasn't anybody from a high-tax State. That was the testimony of Ed Herschler, the Governor of Wyoming, the State that stands to be the "biggest winner," if the deduction is eliminated.

If we believe the administration's rhetoric that this is a subsidy for high-tax States at the expense of the rest, we can't explain why over 35 of the Nation's Governors would rise to defend deductibility. Yet they did. Because they know the issue is not about winners and losers. It is about defending the States ability to collect the taxes they need from revenues they have, and to meet the burdens they face in serving their citizens.

While some States might not benefit as much from deductibility, they receive the benefits of our intergovernmental system through grants to the State and local governments, through defense appropriations, or through direct payments to individuals. For example, the Governor of Mississippi also wrote me in support of the deduction, even though his is a low-tax State which supposedly would profit from nondeductibility.

The citizens might not receive much benefit from the deduction; but for every dollar that Mississippi pays in Federal taxes, its citizens already receive $1.67 in Federal spending.

On the other hand, Minnesotans receive less than they put in: only 87 cents, among the lowest in the Nation.

Now the point is this: Deductibility works like Federal matching programs for State and local expenditures. Mississippi gets its Federal match in larger part through grants, through direct appropriations, or through formual aid based on per capita income, as Senator Javits has pointed out. Per capita income squared formula for AFDC and Medicaid penalizes the District of Columbia, makes the District of Columbia the part of the country that gets the smallest amount of matchig aid, while Mississippi will get the most.

Minnesota gets a greater percentage of Federal aid through a State and local tax match.

Now, I'm not suggesting that each State should receive the same level of Federal spending. But what I am saying is that the deductibility puts the spending decisions at the State and local level, not at the Federal level. These States should not be penalized, nor should the citizens. Individuals with the same incomes, receiving the same services, should not have to pay big differences in their total tax bills.

For example, currently a family with an income of $30,000, in Moorhead, MN, pays $4,400 in State and local taxes. Across the river in Fargo, ND, the same family pays almost $1,000 less. Without deductibility, that gap increases by 22 percent.

Senator Javits gave us the examples of Omaha, St. Louis, and New Orleans. Taxpayers living in a center city such as Omaha, St. Louis, or New Orleans—similarly situated, with similar incomes, and receiving similar services—are different from similarly situated taxpayers in the suburbs of those cities: The city dweller's tax burden is greater by 37 percent.

The answer to the tough question before us—that is, how do we get tax reform and at the same time safeguard federalism—will not be found in the justifications, however well-reasoned they might be. So I was happy to hear that States at opposite ends of the pole on this issue, as well as the Ways and Means Committee, were looking for a compromise. Two years ago and again last January, I introduced a compromise that I believe is simple, is fair to all the States, and contributes its share to rate reduction.

Under my proposal, each itemizing taxpayer would pool his or her State and local taxes and deduct the amount exceeding 1 percent of adjusted gross income. There are other ways to modify the rules regarding State and local tax deductions. Some proposals would repeal the deduction for sales or income taxes, others just the sales tax. But when you examine selective repeal, you see that these proposals come up short with respect to equal treatment for all States, and they demonstrate how far off the mark we can get when we tinker with the engine without understanding it.

From where I sit, Mr. Chairman, any compromise we settle on should not aggravate fiscal disparities among the States. It must respect State and local revenue-raising decisions. And it should contribute to the progressiveness of the overall Federal, as opposed to just the national, tax system.

For some time, it has been clear to me that the lines in the deductibility debate are drawn sharply. There are those who view deductibility merely as revenue foregone. I think they are wrong. There are those who favor sweeping changes without respecting differences among existing State revenue systems. I think they are wrong. There are those who would save the deduction at all costs; but if we value tax reform, and we should, that might not be possible.

So the prizes in this debate should not go to those who refuse to come down off the fence and compromise. Nor should they go to those who would change the system without taking the time to understand it.

It is my hope, Mr. Chairman and my colleagues, that the hearing today will shed new light on the subject of State and local tax deductibility, and that it will bring those who have been unwilling to compromise to the negotiating table. If we don't do that, it might well be the issue on which tax reform fails.

Thank you, very much.

The CHAIRMAN. We follow a first-come, first-serve rule on questions. And the order of the Senators' arrival today was Moynihan, Durenberger, Packwood, Bentsen, Heinz, Grassley and Bradley.

Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman.

I would like first to address a question to Senator Javits, and then one to Senator Durenberger.

The first, then, to a man who has spent many years in public life. I take it the thrust of your argument, Senator Javits, was that the main impact of this proposal would be on education—elementary, secondary education—and the persons who would be most directly affected are children.

Senator JAVITS. Thirty-nine million of them.

Senator MOYNIHAN. Thirty-nine million children.

And it is no coincidence that children don't vote, I suppose.

Well, yesterday we heard testimony from responsible sources that the effect of the removal of the State and the local tax deduction would be to increase the real after-tax cost of school taxes by 40 percent. I take it these are also your calculations, sir.

Senator JAVITS. Yes. We've checked your figures very carefully and have come up with the same.

Senator MOYNIHAN. If we were to repeal State and local deductibles, school districts would have two choices. One would be to cut back their services not simply slow down, but cut back. The second would be to turn to the Federal Government for more assistance.

Senator **Javits**. Absolutely. And with the Federal Government's plan to eliminate deductibility, you must remember—by the Federal Government I mean the executive department—it is almost beyond comprehension to me that the officials carrying the ball are for nondeductibility and are saying there is one issue upon which they will not compromise and that is deductibility. That's a lot of nerve to 108 million people and of the Federal system. And I can't understand it. And I doubt that you gentlemen can understand it either.

Senator **Moynihan**. I very much agree, sir. And we thank you for the eloquence of your remarks.

I'd like just to say——

Senator **Heinz**. Would the Senator just yield to me for just 10 seconds?

Senator **Moynihan**. Certainly.

Senator **Heinz**. I just want to welcome our good friend Jack Javits and my distinguished Governor of Pennsylvania, Dick Thornburgh who is sitting out there in the audience on the next panel. I hope I will be back in time to welcome him personally, but if I'm not, I want him to understand that we have a little situation on the floor that may temporarily preclude me, but I will be back here as soon as I can.

I thank you, Pat, and you, Mr. Chairman.

Senator **Moynihan**. I just want to put a general proposition to Senator Durenberger. Yesterday, we received some figures on the amount various States spend on education and how much of these funds come from the Federal Government. We all looked at these tables and at our own States first: New York State gets 4 percent; Pennsylvania gets 3.2 percent; Minnesota gets 4.1 percent. These are the "low range" States. The high range is 18 percent. These are States that get 18 percent of their total expenditures from the Federal Government.

The numbers are the result of an effort by the high-tax States to help the low-tax States, which are low-tax States very often because they have low income levels.

And the "high-tax" States have lived with less Federal assistance in part because of deductibles.

Would you care to judge? If deductibility is eliminated, what will happen to this sharing of the burden? Isn't it likely to dry up very fast and disappear?

Senator **Durenberger**. I think my predecessors and I have learned something about the way the Federal system has worked, particularly in the last 20 to 25 years in a period of what we call "cooperative federalism." That is, very good ideas for solving problems will inevitably arise some place in this country, and if an idea is good, it will catch on. And somebody with a problem in another State will come and say, well, how did you do it, and soon the idea spreads. Some politician adopts it and incorporates it into his campaign; it ends up as a bill in Congress, affecting all 50 States.

So we have devised approximately 194 different formulas for different programs to make sure that in all 50 States, plus the District of Columbia and the territories and possessions, this new idea—whether it be aid for the handicapped or low-income energy assistance—catches on all over. We now send money off to American Samoa to heat homes. That is how we have traditionally operated, and those States with the internal capacity to tax in order to meet these needs—because they were protected by deductibility—were able to go along with a system that provided these nationally collected revenues for all the States, regardless of capacity.

Senator **Moynihan**. That would seemt to be the logic of the case. I hope it is heard by those who ought to be warned.

And I thank you both, gentlemen, so very much.

The **Chairman**. Senator Grassley, I believe, has a statement he wants to make here.

Senator **Grassley**. I thank you.

I'm sorry I don't have questions, but I want to let you both know how much I appreciate very much your testimony. And Cedar Rapids, IA, was mentioned by Senator Javits. I would like to speak about the entire State and just point out a statistic I'm going to have to observe the same way you are observing as we work with this tax bill. And in now way is that insinuating that I'm against the tax reform package, but in regard to this overall issue of State and local tax deductibility.

I want to suggest that whereas New York is the top effective tax rate State of all with that effective rate being 57 percent, in Iowa, it happens to be 56½ percent, and, of course, that would place Iowa second only to New York. And I would also like to point out that probably the economic disadvantage to Iowa citizens would be even greater than to New York citizens rank well below the national average in their return share of Federal tax expenditures.

I think we are at something like 48, 49, maybe even 50 in some respects. And so I want to point that out for the consideration of my colleagues.

The **Chairman**. Thank you.

Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman.

Let me thank both of the witnesses for their testimony. I think that it's very helpful. And I would like to just ask Senator Durenberger: The rationale for your suggestion, which I think is a helpful suggestion, is that, in your view, the deduction should be worth about the same amount for all taxpayers. Is that not the rationale?

Senator **Durenberger**. Yes. The proposal is premised on the fact that the income tax is good because it is progressive as compared to other taxes. And that the deductibility on the Federal income tax has traditionally been a way to provide incentives for states to use income taxes as a progressive, rather than regressive, form of taxation. So, rather than putting a cap at the top, which would be regressive, I suggested a floor. This would permit States to add taxes on top which would be deductible, thereby preserving progressiveness in deductibility, as well.

Senator **Bradley**. And is there any reason why you picked the 1 percent?

Senator **Durenberger**. I picked 1 percent because at the time, 2 years ago, the revenue on 1 percent was about $6.5 billion, which equalled the amount of money that was going into general revenue sharing, based on one-third State revenue shared and two-thirds local revenue sharing. And my proposition in the new federalism debate was that, in effect, we finance general revenue sharing to State and local governments with some part of the elimination of deductibility. General revenue sharing was perceived as a more efficient way to get a dollar of federally collected taxes into the hands of State and local governments than was deductibility.

That's how I came up with the 1 percent.

Senator **BRADLEY**. Let me thank both of you for your testimony.

The **CHAIRMAN**. Senator Symms.

Senator **SYMMS**. Thank you very much, Mr. Chairman.

I apologize to witnesses that I missed their testimony, but I will carefully look through it. I appreciate both of their sincere points of view. I think this is one of the big issues facing the country with respect to tax reform. And I have to admit that I have been on both sides of this issue at different times in the last 6 weeks, but I think there is probably room for some of us to study this carefully to make up our minds. I think from what I have seen of the progress of tax reform that we will have a lot of time to do it. When I see all the problems arise with the worshipping at the altar of revenue neutrality that the administration is still striving to do, I think we will probably still be talking about it next year and the year after. As long as they maintain they want revenue neutrality, it's impossible to pass tax reform. But that's just one Senator's opinion.

From a parochial point of view, I suppose my State would be one of those on the lower end of the tax rates. I do think, however, that there is a good argument for the federation of States to be independent and be able to raise their own revenue and run their own business, leaving the people on the banks of the Potomac out of it as much as possible. I am very sympathetic with the thrust of your testimony.

Thank you, Mr. Chairman.

The **CHAIRMAN**. Senator Javits, Senator Durenberger, thank you very much.

Senator **DURENBERGER**. Thank you, Mr. Chairman.

Senator **JAVITS**. Mr. Chairman, I would like to thank individually the Senators who arrived a little after we started for being here—Senators Bradley and Bentsen and Grassley and Heinz and Symms. I know how tough it is to get to everything. And I'd like to thank Senator Bradley for taking account of the deductibility of his bill, which he did, and that was, in my judgment, very honorable, and that's why I hardly understand why the administration on this one issue is stonewalling it as if it were holy writ, which it certainly is not.

Thank you, Mr. Chairman.

The **CHAIRMAN**. Thank you very much, Jack.

Next we will have a panel of the Honorable John Carlin, the Governor of the State of Kansas and the chairman of the National Governors' Association; the Honorable Richard Lamm, Governor of the State of Colorado and the chairman of the National Governors' Association Task Force on Tax Reform; and the Honorable Dick Thornburgh, the Governor of Pennsylvania and a member of the executive committee and member of the task force on tax reform of the National Governors' Association.

Gentlemen, if you have no objection, we will take you in the order that you appear on the witness list.

Governor Carlin.

STATEMENT OF HON. JOHN CARLIN, GOVERNOR, STATE OF KANSAS, AND CHAIRMAN, NATIONAL GOVERNORS' ASSOCIATION

Governor CARLIN. Mr. Chairman, thank you very much. members of the committee, we are pleased to have this opportunity to present testimony. I would ask that our full testimony by submitted in the record.

The CHAIRMAN. All of your testimony will be in the record in full.

Governor CARLIN. I would also ask that you enter into the record the statement of Gov. Ed Herschler who would have liked to have been here, but could not.

The CHAIRMAN. Without objection.

[The prepared written statement of Governor Herschler follows:]

TESTIMONY FOR THE RECORD
FROM

THE HONORABLE ED HERSCHLER
GOVERNOR OF WYOMING

HEARING BEFORE

THE SENATE FINANCE COMMITTEE

REGARDING

DEDUCTIBILITY OF STATE AND LOCAL TAXES

July 25, 1985

I am pleased to submit this statement for the record of the hearing to be held July 25, 1985, by the Senate Finance Committee of Congress concerning the federal income tax deduction for state and local taxes. My statement will reflect a fundamental belief that federal policies should avoid influencing state decisions regarding the manner in which states finance and structure delivery of the governmental services which their citizens require.

As Chief Justice Marshall recognized, the states' "power of taxation is indispensable to their existence." Any efforts to limit or influence this power should be treated as a matter of the greatest delicacy. Unfortunately, in the case of federal income tax reform, delicacy has been pushed aside in the rush to achieve other goals. I am hopeful that this committee can interject some delicacy back into these deliberations on tax reform.

Death and taxes, the two certainties of life, have challenged modern man's basic philosophical beliefs for centuries. The proposed federal income tax reform leads us again to philosophical dialogue and debate. While analysts may attempt to characterize the tax reform debate through charts, graphs and tables, the outcome will likely turn on philosophical beliefs and convictions rather than numbers.

Factors such as state sovereignty, fiscal federalism, equity and national security do not easily lend themselves to economic modeling and standardized indices. Nevertheless, they are the basic beliefs and principles that have bound this nation of ours together, with results that are the envy of the world. In today's uncertain economic times, it would be foolhardy to abandon these principles in pursuit of new goals which are framed more by rhetoric than careful and considered analysis.

In a nation which often seems preoccupied with identifying winners and losers, it may seem strange that the governor of a state with relatively low overall taxes would rise in support of retaining the federal income tax deduction for state and local taxes. However, I see more at stake than numbers from the various taxing jurisdictions. The proposed elimination of deductibility threatens to weaken our federation of states, which is the foundation of our nation.

I have seen this threat first hand in a different, but related context, and have often defended Wyoming's state and local taxing decisions from threats of federal interference and pre-emption. In that context, Congress was reluctant to alter the historic and necessary rights of states to formulate their own taxing policies. I am hopeful that a similar reluctance will surface in the debates on the state and local tax deductibility issue. I am also hopeful that Congress will see certain transparencies in the logic which attempts to support eliminating deductibility of state and local taxes.

I find it interesting that the President's tax reform proposal would retain a "limited number of special deductions and exclusions -- principally those that are widely used and generally judged to be central to American values." The numbers I have seen indicate that the state and local tax deductions are among the most widely used of all deductions. In 1982, over 33 million taxpayers claimed the state and local tax deduction while 24.5 million or 25 percent less claimed the home mortgage interest deduction.

Moreover, it appears that use of the state/local tax deduction is particularly widespread among America's middle class. Eighty-seven percent of the returns itemizing state/local tax deductions come from taxpayers with incomes less than $50,000. The middle class are obviously significant users and beneficiaries of the current state/local tax deduction. While it is true that non-itemizers do not benefit from state/local tax deductions, this fact holds true for other deductions which are scheduled for retention under the President's proposal.

Finally, property tax deductibility, which is used by over 85 percent of all taxpayers itemizing state/local taxes, also supports America's unequivocal commitment to private-home ownership. State and local tax deductibility is obviously not a "loophole" that benefits a privileged few. Further, deductibility of state and local taxes is probably one of the simplest of all deductions because of the sales tax tables and the taxpayers ease in recording state and local property and income tax payments.

I have also heard the argument that this deduction somehow unreasonably "subsidizes" high tax states. Frankly, the logic supporting this argument escapes me. A taxpayer's total tax burden in a high taxing jurisdiction is still higher after the deduction, as compared to a taxpayer who benefits both from low state/local taxes and federal tax deductibility. A higher total tax burden doesn't seem to be much of a benefit or subsidy to me.

A major goal of the President's tax reform package is that the ultimate result be "revenue neutral". However, an equally important goal for tax reform should be jurisdictional neutrality. My experience with the divisiveness created by interstate and interregional tax battles, leads me to shy away from tax reform proposals which would fuel such no-win, state _vs_ state confrontations. The potential for these battles and disunity is amplified today by the revenue problems facing state and local governments. Given the prior, significant cuts in federal aid to state and local governments, and the "New Federalism" push for increased state and local revenue responsibility, deductibility has become more important than ever in maintaining the fiscal health and perogatives of state and local taxing jurisdictions.

The need to maintain the fiscal health of state and local jurisdictions, buffer interstate tax differentials, preserve state sovereignty and taxing perogatives, and make federal tax policies more closely reflect "ability to pay" are all important principles that should be preserved under any tax reform. As with most principles, this preservation comes at a cost. However, in these troubled economic times, our nation needs unity. I believe the cost is one we can and must afford to pay.

It is my understanding that the proposal to eliminate state/local tax deductibility is characterized as essential to finance the proposed reduction in marginal tax rates. Perhaps the proposed rate reductions, particularly those benefiting the wealthiest taxpayers, deserve closer examination.

The effect of the non-deductible social security payroll tax on low and middle income taxpayers appears to be overlooked in the debate on appropriate marginal tax rates. Combining the social security tax with the President's proposed brackets makes the total federal tax burden rates approximately 22%, 32% and 35%. The three percent differential between middle class America and the wealthiest Americans does not reinforce the fairness and equity of the President's proposal. This three percent differential is reduced even more when one considers the proposed lower tax rate for capital gains and the link between allowable interest deductions and investment income. These proposals will also primarily benefit the rich.

In light of the complete tax burden picture, Congress might wish to consider retaining deductibility of state and local taxes in return for raising the top bracket from 35 percent to 40 percent. Other options, such as retaining deductibility and adding a fourth bracket to further differentiate between the middle class and the wealthy, warrant investigation.

If there is to be any fair and simple tax reform, there must be compromises which will retain deductions that are widely used and important to American principles and values. As my remarks indicate, I believe the deduction for state and local taxes meets this fundamental test. Any proposal to eliminate state and local tax deductibility should be resisted as contrary to basic intergovernmental philosophies and respect, and against the interests of a healthy and strong union of American states.

Governor CARLIN. I will make some very brief comments, followed by Governor lamm, and, of course, Governor Thornburgh will then follow and we will be open to any questions that you might have.

I think we all very quickly agree in terms of the challenge we face, the tax system that needs to be worked over and improved. The first thing I want to make clear is that we support your efforts as well as the administration's to improve the system.

I want you to know that as Governors we started our work in September of last year and worked through February in a very comprehensive way to develop what you have in detail before you. We took our work seriously, recognizing the tremendous ramifications on the States as well as the importance to the constituents that we share.

I would also want you to understand that we arrived at our policy in February prior to the President submitting his specific proposal to you, and it was approved by a two-thirds plus vote. Although there were disagreements on some of the specifics when it was all put together, there was very, very strong support.

Basically, we support a modified flat tax that broadens the base as the best alternative. But this morning, of course, the issue is deductibility. And I want to make it clear that the resolution of the National Governors' Association very clearly and strongly opposes the total elimination of deductibility. We are willing to discuss compromise.

We are aware that in order for this objective of tax reform to be accomplished that we can't ask for total perfection, but there are ways in which we can accommodate your need for revenue and still protect the basic thrust of deductibility in the system of federalism.

We would hope that the debate would center on fairness, efficiency, equity, and federalism and not regional differences and winners and losers. It is clear that in terms of fairness as you look at the need for revenue to fund what you want to accomplish with lowering the rates—that you have a lot to look at. And we are aware that the deductibility is about 11 percent of that pie that you can go after.

The President's proposal gets 67 percent of what he needs from the deductibility issue alone. We consider that very unfair. In terms of equity of individual taxpayers, the deductibility of State and local taxes is the most frequently used deduction, and the one most important to middle-income taxpayers. And on that basis, as well, we would ask consideration of the issue.

We feel as Governors and representatives of State and local government we have certainly participated in the broader issues of the budget; have certainly taken our share of cuts. We feel that the rationale and support for the long-established deductibility should be maintained at least in principle and think it particularly inappropriate that at the same time we are being asked to do more that you make it more difficult for us to accomplish that mission.

And, again, before I yield to Governor Lamm, I would point out that although cases can be made for some individual taxpayers benefiting, maybe even some States benefiting, we would hope that the issue would be looked at on the basis of what is right or wrong for the future of this country on the basis of sound public policy.

And it's on that basis, certainly, that we adopt the resolution that we have submitted in the testimony that is before you.

I would yield at this time to Governor Lamm.

[The prepared written statement (combined) of Governor Carlin and Governor Lamm follows:]

National Governors' Association

John Carlin
Governor of Kansas
Chairman

Raymond C. Scheppach
Executive Director

STATEMENT OF

THE HONORABLE JOHN CARLIN

CHAIRMAN OF THE NATIONAL GOVERNORS' ASSOCIATION

and

THE HONORABLE RICHARD D. LAMM

CHAIRMAN OF THE NGA TASK FORCE ON TAX REFORM

before the

COMMITTEE ON FINANCE

UNITED STATES SENATE

on

TAX REFORM

July 25, 1985

HALL OF THE STATES · 444 North Capitol Street · Washington, D.C. 20001 · (202) 624-5300

Mr. Chairman and Members of the Committee, we are pleased to appear before you today to represent the National Governors' Association position on tax reform, particularly with respect to the two issues which have an impact on state and local government: deductibility of state and local taxes, and any modifications which affect municipal bonds.

In our remarks this morning, we would like to focus on the following issues:

- The governors' federal tax reform policy,
- The appropriate criteria to evaluate state and local tax deductibility, and
- The potential impact of restrictions on state and local tax-exempt bonds.

Federal Tax Reform Policy

The governors have a strong interest in the efficiency, fairness, and revenue-raising capacity of the federal tax system. Federal tax policy is critical to national productivity and job creation and, thus, to the growth in output and real income. These in turn have a direct effect on the growth in state tax revenues. In addition, state tax policy is closely linked to federal policy; 35 states currently use either federal adjusted gross income, federal taxable income, or federal tax liability as the state tax base for personal income taxes.

The current system, however, suffers from three basic problems: it is complex, inefficient, and unfair. Most of these problems are linked to the existence of the $293 billion in so-called "tax expenditures" which have become part of the individual income tax. A modified flat tax that broadens the tax base is the best alternative for strengthening the federal tax system. It would allow a significant reduction in tax rates which would have a positive impact on incentives to work, save, and invest. These advantages will also be reflected in most state income tax systems since states generally follow federal definitions of income.

With respect to the issue of deductibility, the governors are willing to consider some limited modification, but only in the context that the proposed base-broadening is significant and that any changes not have major differential impacts across states. Elimination of deductibility, as proposed by the Administration, goes considerably further than NGA policy and thus must be opposed.

Concerning bond financing, the governors strongly believe that reforms should not affect the current exclusions of state and local interest payments. Here again, the Administration's proposal and others must be opposed.

The Appropriate Criteria to Evaluate State and Local Tax Deductibility

The efficacy of eliminating state and local tax deductibility should not be debated on the grounds of winners and losers among states. With the exception of a limited number of federal grants, there has never been a clear-cut federal policy in the United States to use fiscal policy to equalize the distribution of income across states — that is, the spending and taxing authority of the federal government. Such a policy is followed in many European countries. For example, in Germany, no state has resources available for providing public services that are less than 92 percent or more than 110 percent of the national per capita average. The United States system, on the other hand, has generally preferred to allow the market to allocate resources across states and has considered diversity to be an inherent strength in our system. If the United States desires to change its system and move toward equality, then it should do so across-the-board so that the net effect of all federal spending and taxes moves toward equality. To single out state and local tax deductibility as the only redistributive component of federal policy is inconsistent with the long-held United States values of market reliance and diversity.

Whether or not curtailment of deductibility is good public policy should not be evaluated on regional grounds. Such a debate distorts the real public policy issues of fairness, efficiency, equity, and federalism.

Fairness - Assuming that the goal of tax reform is to broaden the tax base, then the logical starting point is the list of tax expenditures associated with the individual income tax. The major categories are:

Tax Expenditures	Revenue Loss Fiscal Year 1986 Billions of Dollars
Deductions	$ 98.1
Pension and Retirement Contributions	70.2
Employer-Paid Benefits (except pensions)	27.2
Special Treatment of Capital Gains	26.9
Untaxed Government Benefits	25.4
Business Taxes on Individual Returns	14.2
Other	16.7
Total	$292.9

The estimated federal government revenue loss for fiscal 1986 for all the tax expenditures listed above is estimated to total $292.9 billion. Any serious attempt at tax reform must look at all of these items. Most represent distortions to free markets and thus have a negative impact on long-run economic growth.

Deductibility of state and local taxes represents $33.2 billion, or only 11 percent of this total. The revenue gain from the Administration's modification of all tax expenditures that reduce marginal tax rates would total only $49.4 billion. Thus, state and local deductibility represents 67 percent of the tax expenditure modification, but only 11 percent of the current total. Mr. Chairman, the governors are willing to contribute to tax reform. They are not special pleaders and they are prepared to do their part. However, a plan which asks state and local government — the partners in the federal system — to bear 67 percent of the burden through elimination of deductibility, while continuing more than $243 billion in special exemptions and deductions, is not true tax reform.

Efficiency - The Administration's tax plan, as well as the other several prominent alternatives, are all slightly less complex and perhaps slightly more equitable than the current system. However, a major benefit of tax reform should be one of increased efficiency. Tax reform should stimulate the incentives to work, save and invest by both reducing marginal tax rates and eliminating market distortions. Over the long run, this will stimulate economic growth.

The reduction of the high marginal tax rates from 50 percent to 35 percent will clearly provide incentives for economic growth. However, the failure to limit other deductions which clearly are market distortions represents a major lost opportunity. For example, the continued allowance of a major deduction for interest payments other than mortgages continues to bias our system toward consumption as opposed to savings. Similarly, the failure to cap fringe benefits causes substantial market distortions. For example, the failure to seriously tax employer-paid health benefits contributes toward high inflation in health care costs, which in turn costs the federal government more in Medicaid and Medicare. The continuation of these imperfections in the tax system makes our economy less efficient and less competitive with other countries.

Deductibility does cause state and local spending to be somewhat higher than it otherwise would be; but given the structure of state and local taxes, there is practically no distortion of economic activity by this deduction. One may buy a house or pursue a tax shelter to minimize federal taxes, but no one pays more state and local taxes because of deductibility. In fact, we would go one step further and argue that, as many public surveys indicate, taxpayers believe that there is considerable more efficiency in government spending at the state and local level than at the federal level. Thus, the elimination of deductibility is essentially a long-run shift in revenues, and thus spending, from state and local government which is more efficient to the federal government which is less efficient.

Equity - For governors, a major issue is equity. Under the Administration's plan, only 7 percent of the American taxpayers benefit from the capital gains exclusion. Only four-tenths of 1 percent use the foreign tax credit, and fewer than 1 percent benefit from the proposal for intangible drilling cost and the percentage depletion allowance. By contrast, the state and local tax deduction is used by more people than any other deduction in the federal code — more than that for charitable contributions, or for medical expenses, or for home mortgage interest. In Alaska, 39 percent use this deduction; in Utah, 58 percent; and in Virginia, 41 percent.

The beneficiaries of deductibility are not a privileged class. According to Treasury data, 41 percent of tax filers itemize for state and local taxes. About 51 percent of those who itemize for state and local taxes report income of less than $30,000, and only 13 percent have income above $50,000. This is primarily a deduction for middle America -- for those families where both husband and wife work, who own a home, and who pay most of the federal, state, and local tax burden. State and local tax deductibility is one of their few deductions; few have capital gains, real estate shelters, or special oil and gas tax preferences.

In examining IRAs, which are expanded under the Administration's proposal (and available to non-itemizers as well), 21 percent of IRA beneficiaries make over $50,000 or 61 percent greater than state and local itemizers in the same income tax bracket. Perhaps nowhere in the proposal is the difference between state and local tax deductibility and other tax deductions so clear as in the case of charitable contributions. IRS tables show that filers with income above $50,000 and contributions of more than $3,000 receive 51 percent of the benefits. This compares with less than 32 percent benefit to the same class of persons for state and local tax deductibility.

Federalism - The deduction for state and local taxes is the oldest deduction in the federal tax system. It originally was allowed in a national income tax in 1864 and then later incorporated into the federal code when it was formalized in the individual income tax in 1913. The rationale was to avoid levying a tax on a tax and to provide a more precise measure of the ability to pay. Not only are these arguments still valid today, but more importantly, this deduction has been either implicitly or explicitly woven into every fiscal decision made by state and local government over the last 75 years.

The elimination of tax deductibility will clearly erode the ability of state governments to fund their increasing needs over the next decade. State and local governments will face significant demands for additional investment in the programs for which they are currently responsible. Such demands include responses to needs which were deferred during the early part of the decade, improvements in the quality of current services, growing populations in need of service, and a substantial investment in the infrastructure. By 1990, the increased annual expenditures needed to fully address these demands would include:

- $13.6 billion to fund an expanding demand for health care, particularly for the increasing aged population;
- $3.4 billion for improved correctional services, prison modernization and the reduction of prison overcrowding;
- $15.4 billion for services to a larger school-aged population and improved elementary and secondary education;
- $16.4 billion for restoring and maintaining the federal, state and local highway system;
- $2.1 billion for clean-up and maintenance of hazardous waste sites;
- $4.7 billion for waste water treatment; and
- $8.5 billion for water supply facilities.

Not only are the needs of state and local government increasing, but most expenditures for these levels of government are investments in human and infrastructure capital. Overall, over 38 percent of state and local spending is on education, and 12 percent on infrastructure — roads, highways, parks, etc. The curtailment of these expenditures will have substantial long-run negative impacts on economic growth.

State and local government has already paid a heavy price in terms of lost federal aid as grants will have been reduced by 40 percent in real terms between 1980 and the end of next fiscal year. Governors believe they have absorbed a large share of the deficit reduction. They now believe that they are being asked to pay the price for tax reform by restricting their ability to raise revenues to meet both emerging needs and to offset some of the huge federal reductions in domestic programs. States cannot assume more federal responsibility, receive less money from the federal government, and be restricted in their ability to raise revenues — all at the same time.

Potential Impact - In the short run, states whose state income taxes are linked to federal adjusted gross income will all witness small increases in state revenues. Some of these gains, however, will be offset by reductions in states where taxes are linked directly to federal tax liability. Over the long run, however, the impact will clearly limit state revenue-raising capability and spending. This change will not happen overnight, but legislatures and voters will be more reluctant to raise taxes. The effect is likely to be slower growth in absolute dollars in state and local spending. The estimates of this impact range between 1 percent to 20 percent. Our own sense is that after all adjustments, state and local spending will be 10 percent to 15 percent lower than otherwise would be the case.

Should we worry about this effect at all? In all states, we would still strive for high-quality education, would still maintain roads necessary to get products to market, and exercise compassion for our needy. Our public officials can sell those services in competition with bigger houses, faster cars, and vacations in Europe on a level playing field.

But it is tougher when the field is not level. That is why governors care about balance in the tax reform package. If the bigger house and the faster car are financed with tax-deductible interest, while the schools are financed with tax payments to cover governmental interest payments that are not deductible, the playing field is not level. If the European vacation is a deductible business expense and the safety net is an after-tax cost to taxpayers, the playing field is not level.

Ending deductibility will also probably accelerate some tax changes already being made in state and local taxation. State tax drafters know that deductibility reduces the bite of state income taxes on higher bracket taxpayers. With deductibility gone, there will be a tendency to reduce the progressivity of state income taxes. This will come at a time when many states are reducing their top bracket rates because of increasing evidence that economic development may be as sensitive to them as it is to the tax burden on corporations. For all of these reasons, Mr. Chairman, we must oppose the elimination of state and local tax deductibility.

Alternative Modifications - It makes little sense to end the deductibility of one or two of the big three taxes (sales, income, and property) while leaving the deductibility of others. The revenue increase assumptions used to gauge the effects of selective elimination are inaccurate. For example, if sales taxes are no longer deductible and the other taxes are, states will adjust. They may not eliminate sales taxes, but there will be adjustments. Oregon voters, for example, would not accept the sales tax on which they will soon be voting. Kansas officials will take less interest in relieving local property taxes through state sales tax revenues and more interest in broadening sales tax exemptions. With such major effects on taxpayers, we would find a way to rely more on deductible taxes -- eroding federal revenues and distorting our tax systems as a result.

Another questionable approach is to put a cap on the deduction of state and local taxes with the cap being either an absolute dollar amount or a percentage of adjusted gross income. The absolute dollar cap is good only for raising the taxes of high-income persons. That can be done directly in dealing with the rate schedule and tax breaks which are the province of those with high incomes. The adjusted gross income cap is primarily a penalty for states with the most progressive income tax systems and their taxpayers.

A constructive approach -- in the context of broader tax reform -- may be that of maintaining the deduction for total state and local taxes above 1 percent of adjusted gross income. Such an approach minimizes the differential impacts across states and does not substantially limit our revenue-raising ability over time. Another alternative would be to maintain all current deductions but only allow individuals to take a given share (e.g., 90 percent) of the total as a final deduction. Similarly, it may be possible to add together all current deductions and only allow a deduction for that which is above some percentage of adjusted gross income. While these approaches may not be less complex, they are truly more fair.

The Potential Impact of Reductions on State and Local Bonds

Section 103 of the Internal Revenue Code is one area of the tax code that needs no reform. Changes in tax-exempt bond provisions proposed by the Administration, as well as the plans sponsored by Representatives Gephardt and Kemp, would hinder the ability of state and local governments to raise revenues, and therefore are strongly opposed by the governors. We are no longer talking about the use of industrial development bonds for questionable activities -- we are talking about essential public purpose projects.

Under present law, states and localities have the right to issue and determine the purposes for which tax-exempt financing may be used. The federal Constitution itself preserves that right to states and localities. The Tenth Amendment, federalism principles evident in the structure of the Constitution, the doctrine of intergovernmental tax immunity and the Sixteenth Amendment (which specifically preserved tax immunity), individually and combined, bar federal withdrawal, modification or limitation of the states' authority to issue tax-exempt financings.

Importance to States - State tax-exempt borrowing is a significant and critical portion of state revenues. In 1983 states borrowed nearly $30 billion in tax-exempt financing for which they had a direct repayment responsibility. That figure represented about 8.2 percent of state revenues ranking only after taxes (combined from all sources), federal intergovernmental payments, and insurance trust revenues. By category, revenues from debt financing exceeded money received from the corporate income tax, severance taxes, any single excise tax, license taxes or user fees. In terms of expenditures, states allocated about 5 percent of their annual budgets to debt redemption.

In 1984, overall long-term state and local tax-exempt bonds for all purposes exceeded $115 billion. These bonds were used for the public good. Traditional uses included the acquisition, construction and/or rehabilitation of public buildings, the purchase and rehabilitation of equipment, and the construction and maintenance of our infrastructure, including roads and highways, dams and bridges, airports, docks and wharves. They also provided for the building of public schools, the construction of non-profit higher education facilities, and the provision of student loans.

In the area of health, bond support was provided to public and non-profit hospitals, out-patient facilities and nursing homes. In the area of housing, support was targeted to first-time homebuyers trying to enable them to realize the American dream and the construction of low-income, multi-family rental housing units. Money was also allocated to meeting our environmental needs and specific federal clean air and water mandates. Tax-exempt financing was provided for the construction and rehabilitation of water and sewer lines, solid waste disposal, waste to energy projects and air and water pollution control facilities. Municipal bonds were also important in mass transit. Financings covered the construction of mass transit facilities, the purchase of mass transit vehicles, and the construction of associated parking facilities. The production and conservation of energy was promoted by means of state and local bond financings of facilities for the local furnishing of energy and gas, hydroelectric generation, and local district heating and cooling. Municipal bonds were also a major economic development tool providing for financing of convention and trade show facilities, sports facilities, industrial parks and small businesses which are expanding or rehabilitating facilities.

The Potential Impact - The Administration's plan would eliminate the tax-exempt status of governmental bonds if more than 1 percent of the proceeds were used directly or indirectly by any person other than a state or local government. Representative Kemp (H.R. 2222) and Representative Gephardt (H.R. 800) would eliminate the tax-exempt interest from all but general obligation and traditional revenue bonds.

It is estimated that the Administration's plan would make 62 percent to 80 percent of municipal bonds taxable, including some general obligation and traditional revenue bonds. The 1-percent rule would end all public/private cooperative ventures via the bond market. Privatization of the public sector would end.

- A general obligation bond issued to modernize the local elementary school could lose its tax-exempt status if churches, the Kiwanis Club, or even the Boy Scouts, regularly used the school.
- A general obligation bond whose proceeds financed the construction of a state office building which permitted more than 1 percent of the floor space to be used for an employees' cafeteria under a two-year management contract, and private newspaper stands operated by the blind or disabled, would be made taxable.
- General obligation or revenue bonds issued for road construction could lose their tax-exempt status if the planned road primarily served a major local or regional employer.
- Industrial development bonds financing a publicly owned solid waste disposal facility constructed and operated by a private high technology company would be taxable.
- Industrial development bonds used to construct publicly owned airport terminals and hangars, or harbor wharves and piers, utilized by private carriers would be taxable.
- Industrial development bonds financing construction of air pollution control facilities of major publicly regulated utilities would be taxable even though the facilities were designed to meet federal clean air standards and reduce acid rain.

- General obligation bonds used to provide housing for veterans would be taxable.

The proposals of Representatives Gephardt and Kemp would also eliminate the use of tax-exempt bonds for many critical public purposes. Under both the Gephardt and Kemp proposals, $70 billion of the $115 billion in 1984 municipal bond volume would have become taxable. While states and localities could finance public hospitals with municipal bonds, they could not make tax-exempt financing available to non-profit hospitals which serve many of the same poor and seriously ill citizens. While states could use general obligation bonds to finance, construct and operate waste to energy facilities, they could not use industrial development bonds to create a public/private partnership with a firm that had the expertise, experience, resources and energy needs to ensure a viable project. While states could use general obligation bonds to construct runways, they could not finance airport terminals with industrial development bonds whose repayment would be provided by the user airlines. From a public policy perspective, none of these results makes sense.

The Administration's plan also imposes new arbitrage restrictions and prohibits all advance refundings. The investment of bond proceeds at market rates for a reasonable period of time, pending their application for the purpose of the bond issue, is good cash management. Arbitrage reduces the cost of public projects by reducing the total amount of bonds issued for a project. Advance refunding bonds are desirable where a) interest cost savings of a significant magnitude can be realized; and b) where the elimination of burdensome restrictions, relief of financial distress, or rearrangement of debt service is warranted. States and localities should have the same opportunities to restructure their debt that is available to individuals and corporations. The Administration's plan also applies new restrictions to general obligation and revenue bonds that are presently imposed on industrial development bonds. Such requirements will impose greatly increased administrative burdens on state and local governments and increase their cost.

Proposals Would Cause Reduced Demand for Municipal Bonds - The municipal bond market historically has been dominated by two types of investors: (1) individuals, and (2) institutions, mainly commercial banks and property/casualty insurance companies.

Individual buyers, directly or through mutual funds, are a mainstay of the municipal market. In the fourth quarter of 1983, individuals directly owned 36.6 percent of all outstanding tax-exempt bonds, and indirectly held virtually all of the tax-exempt bonds in mutual funds, another 24 percent of the total outstanding supply. The proposals to reduce individual income tax rates will lessen the incentive of individuals to buy and carry tax-exempt bonds, and therefore increase the interest rates and borrowing costs to be paid by state and local governments to sell those securities.

The proposals to reduce corporate income tax rates will also reduce the incentives for corporate purchasers to buy and carry tax-exempt bonds. Commercial banks, which have purchased between one-third and two-thirds of municipal issues over the last 25 years, will be particularly discouraged from investing in tax-exempt bonds by the Administration's plan, which modifies the corporate minimum tax so that it further reduces the deductions taken by banks and other financial institutions for the costs incurred in buying and carrying tax-exempt obligations.

Higher Borrowing Costs - The cost of borrowing by state and local governments is affected by the relative risk to tax-exempt bond purchasers. One element of risk is the risk of default. Municipal bond insurers have already indicated that they expect the loss of deductibility of state and local taxes to itemizers to impose practical limits on the ability of state and local governments to raise taxes and user fees. The reduction in revenues, they say, will lower bond security and increase borrowing costs. They indicate that about half of all bonds currently eligible for municipal bond insurance would be made ineligible, or eligible only at significantly higher premiums.

If state and local governments had to issue taxable bonds for public projects, it is estimated that the average cost of financing would increase by 25 percent to 35 percent. Assuming a 3 percent interest rate differential between issuing at taxable rather than tax-exempt rates, states could expect the projects to cost an additional $41 billion over a five-year period of time.

Coopers and Lybrand has just completed an analysis of Treasury's estimates of revenue gains from the proposed elimination of selected tax-exempt securities. It concludes that the anticipated revenue gains from the elimination of these tax-exempt bonds would be less than $2 billion over the five-year period. This is substantially below the estimate of the Treasury Department. Thus, the revenue gain to the federal government is expected to be very small, while the costs and disruption to state and local government are potentially very large. Such changes in the tax code are thus strongly opposed by the governors.

Conclusion

In conclusion, Mr. Chairman, the governors support meaningful tax reform that follows the general guideline of broadening the base and reducing marginal tax rates. We are willing to consider some modification of state and local tax deductibility as part of a comprehensive tax reform plan, but the total elimination of deductibility is opposed.

We also are strongly opposed to recommendations regarding tax-exempt bond financing. In 1980, 1982, and again in 1984, Congress acted to place restrictions on industrial development bonds, mortgage subsidy bonds, and student loan bonds. Specific purposes deemed abusive were simply eliminated and additional restrictions were imposed. New substantive restrictions, state-by-state volume limitations, and curbs on arbitrage were enacted in 1984. Additional reforms are not necessary and will only cause substantial financial disruption to state and local government for very little revenue gain to the federal treasury.

The Administration's proposals regarding deductibility and tax-exempt funding represent about $35 billion or 71 percent of the modifications that are used to reduce marginal tax rates. Why should state and local government — the partners in the federal system — pay 71 percent of tax reform when over $240 billion of special tax exemptions, deductions, and credits continue to be maintained? The states are prepared to do their share; however, they cannot do it all. We have already paid most of the price of deficit reduction in terms of reductions in state and local grants. You cannot ask us to continue to increase our responsibility, provide us with less federal assistance, and then substantially restrict our ability to raise revenues through taxes and debt financing. Mr. Chairman, this is not fair, equitable, or efficient; and it represents a major step back in American Federalism.

The CHAIRMAN. I might make a few comments, if I might, about Dick Lamm, who is an old, old friend of mine. He was in the Colorado State Legislature, when I was in the Oregon Legislature, and we both had an interest in the subject of abortion and a woman's right to choose. And Colorado is one of the early reform States in that area before the Supreme Court's decision in 1973. And I met him when we were in the legislatures and he was national president of Zero Population Growth when I was active in that.

I do recall when I went out to see him—he was Governor by this time—a year or two after the Supreme court decision on *Rowe* v. *Wade* and we thought we had won the issue; that that battle was over. And that night he and his wife, Dotty, took meup to an opera house in one of their old silver towns and we saw an opera. And it was raining somewhat hard as we went up, and when we came out it was pouring down rain. And I thought to myself if that rain is raining that hard off those hillsides, those rivers are going to come up, and sure enough, by the time we got out, we were almost blocked from getting back. He let me stay at the mansion that night. I think you were gone by 5 o'clock in a National Guard helicopter the next morning looking over the damage. And I supppose I should have realized that as a harbinger of our mutual interest on a woman's right to choose that, indeed, the battle wasn't over. The rain was a bad omen. But, Dick, it's good to have you with us.

STATEMENT OF HON. RICHARD D. LAMM, GOVERNOR, STATE OF COLORADO, AND CHAIRMAN, NATIONAL GOVERNORS' ASSOCIATION TASK FORCE ON TAX REFORM

Governor LAMM. Thank you, Mr. Chairman. I do remain a fan of yours and appreciate the good things you fight for.

The beneficiaries of deductibility are certainly not a privileged class of people. According to the Treasury data, 41 percent of the taxfilers itemize for State and local taxes. And 87 percent of these people have income below $50,000 a year. This is a middle-class-America deduction.

A few people have capital gains; have real estate shelters or special oil or gas tax preferences. This deduction, as you know, is used by more people than any other deduction in the Federal Code. And it seems to me that that is a very important item.

The second thing that I'm here to talk about is the efficiency, because I do think when you write a Tax Code you simply have to take into account the efficiency. What the tax laws say somewhat dictates a whole, wide variety of economic activity. It is an incentive for economic growth or it could be a disincentive. But the failure to limit other deductions in this tax plan that have very severe market distortions, I think, represents a major loss of opportunity. For instance, the failure to seriously tax employer-paid health benefits contributes toward high inflation in health care costs. I know it's controversial, but it simply adds to the inflation. It is an economic motivator.

But the deductibility of State and local taxes does not seem to me to be an economic distortion. People may buy a house or pursue an oil and gas investment to minimize their Federal taxes, but no one pays more in State and local taxes because of deductibility.

I'm also asked to speak a little bit on municipal bonds. State tax-exempt borrowing is a signficant and critical portion of State revenues. States last year borrowed some $30 billion by tax-exempt financing for which they had a direct repayment responsibility. It is estimated that the administration's plans would make 62 to 80 percent of municipal bonds taxable, including some general obligation and traditional revenue bonds. The 1-percent rule would end all public-private cooperative ventures via the bond market.

If the State and local governments had issued taxable bonds for public projects, it is estimated that the average cost of financing would increase by 25 to 35 percent. And that could add an additional $41 billion over a 5-year period of time.

So the potential revenue gain from this, on the question of municipal bonds, is $2 billion a year. The revenue loss is not anywhere proportionate to the cost of State and local governments, which is potentially very large. We ask that you carefully look at that provision also.

Let me summarize the National Governors' Association testimony here today. We do support meaningful tax reform that follows the general guidelines in our resolution of broadening the tax base, reducing the marginal rates. We are willing to consider some modification of State and local deductibility as part of a compromised tax package.

But as Governor Carlin said—with only 11 percent of the tax expenditure, we are being asked to provide 71 percent of the modifications that are used to reduce those marginal rates. Why should State and local governments, the partner in the Federal system, pay 71 percent of tax reform when over $240 billion of special tax exemptions, deductions, and credits continue to be maintained?

The States are prepared to do our share, but we can't do it all. And we are being asked to unjustly give more than our percentage of the problem. We have already paid most of the price of deficit reduction in terms of reduction in State and local grants. You cannot ask us to continue to increase our responsibilities, provide us with less Federal assistance, and then substantially restrict our ability to raise revenues through taxes and debt financing. It is not fair. It is not equitable. It is not efficient.

Thank you.

The CHAIRMAN. Thank you.

STATEMENT OF HON. DICK THORNBURGH, GOVERNOR, COMMONWEALTH OF PENNSYLVANIA, MEMBER, EXECUTIVE COMMITTEE AND MEMBER, TASK FORCE ON TAX REFORM, NATIONAL GOVERNORS' ASSOCIATION

The CHAIRMAN. Governor Thornburgh.

Governor THORNBURGH. Mr. Chairman, members of this committee, I appreciate the opportunity to appear before you today.

Since the President introduced his tax reform proposal, there have been a great many statements as to what the Governors are for or against. As a Governor who is a member of the executive committee of the National Governor's Association and who is also a member of the association's task force on tax reform, I would like to offer my personal perspective.

First of all, I think it's important to note that the full association, its executive committee nor the tax reform task force have met since the President introduced his tax reform proposal. It will be a lively subject for discussion, I expect, at our summer meeting beginning next week in Senator Symms 'home in state of Idaho.

Our policy, which you have, doesn't even mention tax deductibility. Consequently, any interpretation, including my own, as to how the President's plan fits with the NGA policy adopted this past winter must include a goodly amount of conjecture.

My feeling, which I believe is widely shared by the Governors and by the American people, is that the current tax system is complex, inefficient, and unfair. That system, through its patchwork of loopholes, credits, exemptions, and deductions, results in individuals with similar yearly incomes paying vastly different taxes. Furthermore, the complexity of the system and its high marginal tax rates inevitably discourage incentive and encourage tax evasion.

There is a need for tax reform. We need a system that is simple and fair, and perhaps just as importantly, one that is perceived to be fair.

President Reagan's plan, by adoption of a modified flat tax rate with a maximum rate of 35 percent, should go far toward returning a sense of fairness and equity to our Federal tax system, a system which incidentally could learn much from Pennsylvania's simplified flat tax with a rate that is low and is going lower. Because there is not fast and complex array of deductions in the Pennsylvania tax system, our taxpayers can utilized a one-page return, fill it out in 30 minutes and normally without any professional assistance. Furthermore, we have experienced fewer areas of omission or commission and observe less incentive for evasion or avoidance due to the simplicity of our tax.

The plan put forward by President Reagan, if adopted in toto today by this Congress, would instantly work dramatic improvements in the Nation's tax climate and benefit the vast majority of the Nation's taxpayers.

Special interest groups by the hundred seeking to protect a whole variety of special treatment provisions in the maze of current tax law have and will, no doubt, continue to come to members of this committee and other Members of Congress pleading their special cases. They have a tax advantage now, and understandably they want to keep it.

States are no exception. Some of the provisions found in the current tax system, for example, allow Pennsylvania and local government units to issue tax-free industrial development bonds and provide investment credits such as those for historical rehabilitation. These have been very useful tools in our economic and community development programs. They have had and still have my strong support. Moreover, I will fight to preserve these tax provisions which favor my State, if the tax reform effort gets bogged down in a prolonged debate over special breaks for one group after another.

My hope, however, is that the Congress will not take such a course of action. If there ever was an issue that requires all of us to place the public interest above the special interest, it is tax reform. If ever there was a time to do so, it is now. If we all work together, public officials at all levels of government, from all parties, we can reform this Tax Code which has made it impossible for so many Americans to even know what our tax laws are, let alone fill out their 1040 forms in good faith without a battery of CPA's and lawyers.

Let me address on further matter. Some of the special State interests you have heard from are those who are upset by the President's proposal to eliminate the deduction for State and local taxes. I disagree with those Governors, and not just because Pennsylvania is a low-tax State whose taxpayers would be net gainers from the President's proposal. I believe that ending this deduction is a reasonable and equitable price to pay for signficicantly reducing the average American's tax burden. The President's plan calls for lowering personal tax rates and replacing the current 14 brackets and tax rate range from 11 to 50 percent with broad brackets of 15, 25, and 35 percent, which coupled with increases in the personal exemption will benefit all taxpayers.

The Advisory Commission on Intergovernmental Relations, upon which I am privileged to serve, has calculated that 79 percent of our taxpayers, including many of those who currently deduct State and local tax payments, will get a tax cut or pay the same amount in Federal taxes as a result of these changes. Overall, according to ACIR, individual tax liability will be reduced by an average of 8.5 percent. The current system of allowing for deductions of State and local tax payments has, again, according to ACIR, generally worked to the advantage of a small percentage of persons with high incomes living in States with high and steeply graduated tax rates. The two-thirds of Americans who do not itemize their deductions get no benefit at all from this provision and end up, in effect, subsidizing those who do.

The average citizen in the 34 lower tax States ends up subsidizing, in effect, high-income taxpayers in higher tax States, taxpayers who in my view neither deserve nor need such subsidization.

Three other points have been referred to by my colleagues this morning, and I would like briefly to address them. First, it is said that the President's proposal is unfair because 67 percent of the revenues would come from eliminating this deduction, which represents only 11 percent of the total deduction. If these revenues were going to be used to increase vast new spending programs or to reduce the deficit, I would wholeheartedly agree with that observation. But they are not. These revenues will be returned to all taxpayers in all States in a way that will reduce the overall tax burdens for the vast majority of them. I ask what could be fairer than this.

It is said as well that the plan is inequitable in that it takes away a deduction which is used primarily by middle-class Americans. Only 50 percent of the median-income households, however, use this deduction. And even those people are not the ones primarily benefiting from it. According again to ACIR, the top 20 percent of the taxpayers in the highest income brackets claimed 80 percent of the total amount deducted for State and local taxes in 1982, the latest year for which figures are available. In fact, the majority of median-income households will pay lower taxes under the President's plan than they do today.

Finally, it is said that eliminating the deduction will restrict the ability of State and local governments to raise revenues. I've been Governor of a low-tax State for 6½ years. As many of you know, raising txes is a painful experience for any political leader, regardless of a high- or low-tax environment. Never once, however, did anyone ever suggest to me that I should raise taxes because 29 percent of the Pennsylvania households would be able to deduct them from their Federal returns.

The choice is simple—either to continue a tax break which benefits only one-third of all taxpayers and those in the high tax brackets in high-tax States at that, or to provide lower tax rates for all taxpayers in all States, as the President has proposed. To me, the answer is obvious.

I'm asking members of this committee to rewrite the tax laws to make them simpler and fairer to resist efforts by the special interests to protect their tax breaks. Move the President's plan forward without unraveling it. For the average American, many businesses, it is a giant step forward and a vast improvement over our current system.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Governor.

[The prepared written statement of Governor Thornburgh follows:]

TESTIMONY OF GOVERNOR DICK THORNBURGH
COMMONWEALTH OF PENNSYLVANIA

BEFORE

A HEARING ON TAX REFORM

OF THE
UNITED STATES SENATE
COMMITTEE ON FINANCE

July 25, 1985

Mr. Chairman and Members of the Committee:

I appreciate the invitation to appear before you today.

Since the President introduced his tax reform proposal, there have been a great many statements as to what "the governors" are for or against. As a governor who is a member of the Executive Committee of the National Governors' Association (NGA) and who is also a member of the NGA Tax Reform Task Force, I would like to offer my perspective.

I should like to point out that neither the full NGA, its executive committee, nor the Tax Reform Task Force have met since the President introduced his tax reform proposal, which I am sure will make for a lively discussion at our summer meeting beginning next week in Boise, Idaho. Consequently, any interpretations, including my own, as to how the President's plan fits with the NGA policy adopted this past winter includes a goodly amount of conjecture.

My feeling, which I believe is widely shared by the governors and by the American people, is that the current tax system is complex, inefficient and unfair. That system through its patchwork of loopholes, credits, exemptions and deductions results in individuals with similar yearly incomes paying vastly different taxes. Furthermore, the complexity of the system and its high marginal tax rates can inevitably discourage incentive and encourage tax evasion.

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There is a need for tax reform. We need a system that is simple and fair and, perhaps just as important, one that is perceived as fair.

President Reagan's plan, by adoption of a modified flat tax with a maximum rate of 35 percent, should go far towards returning a sense of fairness and equity to our federal tax system -- a system which, incidentally, could learn much from Pennsylvania's simplified, flat tax with a rate that is low and going lower. Because there is no vast and complex array of deductions in the Pennsylvania tax system, our taxpayers can utilize a one-page return and fill it out in 30 minutes, normally without professional assistance. Furthermore, we have experienced fewer errors of omission or commission and observed less incentive for evasion or avoidance due to the simplicity of our tax.

The plan put forward by President Reagan, if adopted in toto today by this Congress, would instantly work dramatic improvements in the nation's tax climate, and benefit the vast majority of the nation's taxpayers.

Special interest groups by the hundreds seeking to protect a whole variety of special treatment provisions in the maze of current tax law will no doubt come to members of this committee, and other members of Congress, pleading their special cases.

They have a tax advantage now, and understandably they want to keep it.

States are no exception. Some of the provisions found in the current tax system, for example, allow Pennsylvania and its

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local government units to issue tax free industrial development bonds and provide investment credits such as those for historical rehabilitation. These have been very useful tools in our economic and community development programs. They have had and still have my strong support. Moreover, I will fight to preserve those tax provisions which favor my state if the tax reform effort gets bogged down in a prolonged debate over special breaks for one group after another.

My hope, however, is that Congress will not take such a course of action. If there was ever an issue that requires us to place the public interest above the special interests, it is tax reform. If ever there was a time to do so, it is now.

If we all work together, public officials at all levels of government from all parties, we can reform this tax code which has made it impossible for so many Americans to even know what our tax laws are, let alone fill out their 1040 forms in good faith, without a battery of C.P.A.s and lawyers.

Let me address one further matter. Some of the special state interests you have heard from are those who are upset by the President's proposal to eliminate the deduction for state and local taxes.

I disagree with those governors, and not just because Pennsylvania is a low-tax state whose taxpayers would be net gainers from the President's proposal. I believe that ending this deduction is a reasonable and equitable price to pay for significantly reducing the average American's tax burden.

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The President's plan calls for lowering personal tax rates and replacing the current 14 brackets and a tax rate range of 11-50% with broad brackets of 15-25-35%, which coupled with increases in the personal exemption, will benefit all taxpayers.

The Advisory Commission on Intergovernmental Relations (ACIR) has calculated that 79 percent of our taxpayers, including many of those who currently deduct state and local tax payments, will get a tax cut, or pay the same amount in federal taxes, as a result of these changes.

Overall, according to ACIR, individual tax liability will be reduced by an average of 3.5 percent.

The current system of allowing for deductions of state and local tax payments has, according to ACIR, generally worked to the advantage of a small percentage of persons with high incomes living in states with high and steeply graduated tax rates.

The two-thirds of Americans who do not itemize their deductions get no benefit at all from this provision, and end up subsidizing those who do.

The average citizen in the thirty-four lower tax states ends up subsidizing high-income taxpayers in higher tax states -- taxpayers who neither deserve nor need such subsidization.

Three other points frequently made by some of my colleagues for opposing the elimination of deductibility deserve some attention.

It is said that the President's proposal is unfair because 67 percent of the revenues would come from eliminating this deduction, which represents only 11 percent of total deductions.

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If these revenues were going to be used to increase spending or reduce the deficit, I would agree with them. But they are not. These revenues will be returned to all taxpayers in all states in a way which will reduce the overall tax burden for the vast majority of them. What could be fairer than this?

It is said that the plan is inequitable in that it takes away a deduction which is used primarily by middle class Americans. Only 50 percent of the median income households, however, use this deduction, and even these people are not the ones primarily benefiting from it. According to ACIR, the top 20 percent of the taxpayers in the highest income brackets claimed 80 percent of the total amount deducted for state and local taxes in 1982, the latest year for which figures are available. In fact, the majority of median income households will pay lower taxes under the President's plan than they do today.

Finally, it is said that eliminating the deduction will restrict the ability of state and local governments to raise revenues. I have been governor of a low tax state for 6-1/2 years. I can assure you that raising taxes is a painful experience for any political leader, regardless of a high or low tax environment. Never once, however, did anyone ever suggest to me that I should raise taxes because 29 percent of Pennsylvanian households would be able to deduct them from their federal returns.

The choice is simple: either to continue a tax break which benefits only one-third of all taxpayers, and those in the high

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brackets in high-tax states at that, or to provide lower tax rates for all taxpayers in all states, as the President has proposed. To me, the answer is obvious.

I call upon members of this committee to rewrite the tax laws to make them simpler and fairer, and to resist efforts by the special interests to protect their tax breaks.

Move the President's plan forward without unravelling it. For the average American and many businesses it is a giant step forward and a vast improvement over our current system.

# # #

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. Thank you, Mr. Chairman.

Excellency, we are very honored to have you with us today. I have just a couple of questions I would like to ask and one general statement I would like to make. I think that this committee—at least some of us here—is concerned that in the course of undertaking to reform the Tax Code, which in all truth we do every other year, we are going to alter the Constitution. I mean by this we are going to change the constitutional balance in some fundamental way. Senator Javits has described so well of the increasing efforts of the Federal Government in the last quarter century to reduce inequities in the American Federal system. As a result of this effort, there arose some concern that the Federal Government was getting too large.

In response to this concern, President Kennedy initiated—and President Nixon finally adopted—revenue sharing. This was a very specific proposal to turn revenue back to State governments and local governments and to permit decisions to be made there.

Now we have lost revenue sharing. And if we lose State and local tax deductibility, there is going to be one ineluctable process—that is, more and more decisions will be made in Washington.

I would like to ask all of you one question. I was surprised to learn that the Treasury Department describes this provision, which has been in the Tax Code from the beginning, as a Federal subsidy. There is something perverse about this proposition—any money the Federal Government doesn't take from you, it has somehow allowed you to keep, as if it was theirs to begin with. A Federal subsidy, it would appear, is the amount of money that the Treasury does not collect as taxes.

And just this very word, subsidy, changes the whole political debate. It is a most arrogant assertion that the government owns your income—what it does not take from you is something it has given to you.

The **Chairman**. Let me interrupt and recall to memory. You weren't here at the time, Pat, but in 1974-75 Ed Levy who became our Attorney General but was then the dean of the Law School at Chicago testified—we were on tax reform then as we are now—and he took exactly this theory that you were talking about. About it belongs to us, but we will let you keep some of it. And he said I don't know where these tax reformers get this idea that that's a new theory. He said that's been around for centuries. We used to call it feudalism. [Laughter.]

Senator **Moynihan**. Well, welcome to the court.

But there is another subsidy that I would like to ask you about: the Federal tax exemption for the interest on State and local government bonds. Would you consider it? For a number of years, the Office of Management and Budget would put out special analyses of different aspects of public finance, up until 1982 when they stopped it. There was a table, S9 which listed the present value of the subsidies for new issues of State and local government bonds.

In the year 1982, it was estimated that the tax loss to the Federal Government for new bond issues was $23 billion and the borrower benefit was $16.5 million, which meant to say that there was a difference of $8 billion that went solely to the people who owned these bonds. These obviously, are not low income people. The Federal Government is already describing this as a subsidy. Would it occur to you—if we go about declaring the State and local deduction to be a subsidy that the next subsidy we will eliminate is the ability of States to issue tax-exempt bonds?

Governor CARLIN. I would imagine you are going to consider them both. I would, particularly on the bond side, remind you that very recently you have made some changes that restrict considerably the use of tax exempt borrowing.

Senator MOYNIHAN. Of the IDB's?

Governor CARLIN. Yes. And rightly so, I would say quite candidly. And I would respectfully suggest that that issue should not be on the table. You have addressed it, and it ought to be allowed to proceed forward and see after a few years' experience as to whether or not further change should be taken place.

Senator MOYNIHAN. Governor, make the point that the Office of Management and Budget has already described that as a subsidy, a loss in Federal tax revenues. If we eliminate one subsidy, won't we end up getting rid of the other?

Governor LAMM. Mr. Chairman, I think it really goes to the heart, your suggestion. I mean we are separate sovereigns.

Senator MOYNIHAN. Right.

Governor LAMM. In fact, we are separate units of Government, and it seems to me—it's like the word "loophole." The President proposes a plan where if, you know, you borrow a lot of money to buy some ridiculous extravagance, you can deduct that, but if you go to build a school house or if, you have some other State and local expenditures, which are extremely important expenditures then no deduction for things that keeps society going.

Senator MOYNIHAN. Governor, I completely agree. When did Washington start describing the oldest fiscal practices of the States of the United States, as a Federal subsidy?

Governor LAMM. You can go back to 1913. We do take it up on page 9, and we go into great detail. We talk in terms of the 10th amendment, the federalism principles evident in the structure of the Constitution, the doctrine of intergovernmental tax immunity and the 16th amendment. All of these argue that this is not simply a another loophole in the tax law. This is an integral part of intergovernmental respect.

Senator MOYNIHAN. Thank you, sir.

Governor THORNBURGH. Mr. Chairman, may I speak to that?

The CHAIRMAN. Yes.

Governor THORNBURGH. I will round out the trilogy of Governors you have got here. I might say at the outset, Senator Moynihan, that I think the revenue-sharing proposal that was incorporated into our fiscal picture during the 1970's was a very positive addition and a useful way to enhance the capabilities of States in dealing with their problems. However, in the 1980's when it is no longer revenue sharing, but the sharing of proceeds of Federal borrowing, which would tend to drive the deficit up higher and increase the load upon every citizen, I think that it quite properly was looked at as a candidate for excision. And we at the State level no longer have it, President Carter having removed that in 1981, and the present administration now seeks to do the sme thing with regard to local revenue sharing.

I think the principal is good if the revenue is there.

Second, my former boss Ed Levy, with whom I proudly served in the Department of Justice, when he was Attorney General, makes a very apt observation. It would be apt to this situation if the proposal was that moneys be taken from State and local governments by eliminating the deduction for State and local taxes. That's not the case.

First of all, it's not a loss of dollars to the State and local governments. It's a loss of dollars to certain taxpayers who reside in States and local communities. Moreover, it is not a loss to the aggregate taxpayer in that these sums are then turned around and redistributed in what I would content to be a far more equitable manner than the system which presently provides benefits disproportionately for high-bracket taxpayers in high-tax States.

With regard to tax-exempt State and local financing, I think there are two things that have to be pointed out. One is we have been enthusiastic users of that vehicle in the Commonwealth of Pennsylvania. I believe we lead the Nation in that regard. And as I said in my testimony, they have been very useful. And, frankly, if the unraveling process that I fear occurs with regard to the President's tax reform plan, it is the one area where this Governor would raise strenuous objection to not including in that unraveling a return to tax-exempt status.

Nonetheless, I think all of us, if we are in good faith about tax reform, recognize that there are certain benefits that each and every one of us enjoy that have to be given up in the greater good of simplifying and providing more equitable tax treatment for all Americans. And in that sense, I think that my colleagues and I have taken the position that most everything must be on the table and up for discussion, including the tax-exempt status of State and local financing, provided it is part of a broad, comprehensive tax reform effort.

Senator MOYNIHAN. Thank you. My time is up.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Governor Thornburgh, you have me at a slight disadvantage with all the ACIR statistics, because I didn't get your statement until this morning. And since we both serve on the commission, I need to ask you a couple of questions that stretch you beyond your office as Governor of a so-called low-tax State.

But, first, with regard to the statistics: According to one figure, only 50 percent of median-income households use the deduction. I have a letter from the Assistant Secretary of the Treasury, in response to a question I had asked him at a hearing in June, in which he indicates that 72 percent of the taxpayers with incomes at $20,000 or more utilize the deduction.

Governor THORNBURGH. The difference between taxpayers and households, I think.

Senator DURENBERGER. Perhaps. Maybe it is.

I am concerned about two things. One is, where does this rank on your list of priorities in getting to major tax reform? Where does it rank in relationship to the investment tax credit, to changes in ACRS? I had the heads of five or six of the Nation's major steel companies in my office telling me that they are bankrupt, and that a flat-rate tax is not going to save them. So, maybe as Governor of Pennsylvania, you can tell me whether this $31 billion is more important than that $31 billion, and where we, who have to try to get to the end of this, give up.

The second thing that concerns me relates to the notion of the deficit and Federal spending, and also the notion that deductibility might not be the most efficient way to get money from one level of Government to another, but, in effect, it is a matching program. You pay $1 of property tax in Pennsylvania, and the Federal Government matches that with 50 cents, if you happen to be in the 50-percent tax bracket.

But the pressure is on the spending side—the decisions on the spending side are in Pennsylvania or in the city of Harrisburg, if that is where you live.

Now, Pennsylvania is a little different. Yes, it's a low-tax State; but Pennsylvania was 10th among the States in the award of Federal contracts in 1984. My State was 37th or 38th. Pennsylvania ranked 11th in terms of Federal per capita domestic expenditures, and my State was 31st. Pennsylvania ranked fourth in terms of direct payments to individuals, which we were talking about here earlier. Minnesota was 38th. Those payments have a direct impact on people, people in need of Medicaid, AFDC, housing, and more. And Minnesota then could end up being a high-tax State because it ranks 38th in terms of the response of the Federal Government. How do you, as you look at this from a national perspective, justify that disparity?

Governor THORNBURGH. Let me try as best I can to answer those in the order you asked them. With regard to priorities, I think what many of us look at in the attributes of the elimination of deductibility of State and local taxes as the price tag for securing overall lower marginal rates is the attribute of fairness. That is to say rather than having a system which provides benefits to only one-third of the taxpayers—those being high bracket taxpayers in high-tax States—why not use that same amount of dollars to provide benefits for all taxpayers in all States—and that's a zero sum proposition in rough terms, in my view in conceptual terms.

When you look at ACRS and the investment tax credit, which are available to our smokestack industries, conceptually they have a great deal of appeal. I, frankly, would have been more supportive of those concepts, however, if I had actually seen some investment made in the State of Pennsylvania by those who claim they will be hampered and prejudiced by the loss of the present provisions in the law. The fact of the matter is that so far as my state is concerned, as far as the steel industry generally is concerned, which is one of our principal industrial base concerns, there has not been a great deal of new investment made using either the ITC or the ACRS provisions since they have been on the books.

Senator DURENBERGER. But that is not giving both of them up? You think we ought to give both of them up, plus let those steel companies sit there with their unused tax credits and not be able to use them, which is part of that proposal.

Governor THORNBURGH. I'm talking about an overall comprehensive reform system where everything has to be on the table, and if the attributes that I see in the overall system are forthcoming, then I think you have to look lower down on the priority list to the retention of those particular features.

I think there is—and I would suggest to the attention of the committee utilizing what we have done in Pennsylvania, and that is taking those unused credits and over a finite period of time tieing them to actual investments so that some benefit will be forthcoming and some additional incentive will be there. But the notion of retaining these on the books in perpetuity, in view of the somewhat limited use that has been made of them up to this point, I think, makes it negotiable.

The question of whether or not there is an equivalency beeween the deductibility of State and local taxes and the vast array of Federal programs that are designed to aid States—some of the statistics you noted—where there is an obvious disproportionate feature built in, that every dollar paid in does not go back dollar-for-dollar to the States, I think turns on looking at what the process is and who the beneficiaries are. With regard to the deductibility of State and local taxes, that deduction accrues to individuals. It is to their benefit. It provides a break, as I have noted, to a group of taxpayers who I would think would be among the least of those about whom we are——

Senator **DURENBERGER**. $20,000 a year or more. Remember, 72 percent of them earn $20,000 a year or more. That's just barely above the poverty line.

Governor **THORNBURGH**. I think it's less important, Senator, if I may suggest, to look at how many people take it as to what the dollar value is. And here the top 20 percent of the taxpayers get 83 percent of the dollar value of the deduction. And that, clearly, is the basis of the ACIR finding that this is primarily of benefit to peopel in higher brackets and higher tax States.

But the fact of the matter is the beneficiaries of the present deductibility of State and local taxpayers are primarily inviduals in high-tax brackets. The beneficiaries of the type of programs that you have described and the whol array of Federal programs are people who have identified needs for whom a——

Senator **DURENBERGER**. The beneficiaries of deductibility are taxpayers whose taxes support all of the people earning below $20,000.

Excuse me. I guess I ran out of time.

The **CHAIRMAN**. Let me start with Governor Carlin and move to the subject of bonds rather than State and local tax deduction.

In your judgment, is there any purpose for which a state or any one of your local subsidivisions might want to issue a Government bond and call it a 'public purpose' that the Federal Government should deny tax-exempt status on, or should the decision as to the definition of public purpose be totally within your jurisdiction and we automatically grant it tax-exempt status?

Governor **CARLIN**. I think it would be reasonable to discuss a certain set of criteria so that any abuses that might be suggested that are ones that can be backed up, those abuses be limited or certainly reduced. I don't know specifically what you are making reference to, but, again, tieing back to the revenue bonds, there were abuses. And although it's somewhat, you know, general in terms of how we approach it—we just put a cap—it does force us to be more selective, and, therefore, go to those projects that bring the greatest return for use of the program.

The **Chairman**. I will give you a specific. I don't know if Senator Bradley was here when your Director of Economic Development testified. I was quite impressed with him. He seemed to know what he was about in terms of tracking industry, and we were talking about industrial development bonds. And he just very frankly said, no, that's a public purpose; providing jobs is a public purpose. And he even went so far to say if the law allowed it, he would try to use industrial development bonds to attract the Satern plant.

Now General Motors is going to locate that plant some place and if the purpose of the bonds is to allow Kansas to outbid Colorado to outbid Pennsylvania, all the no-net benefit to the Federal Government—the plant is going to go some place anyway—should you be allowed to use bonds for that kind of purpose?

Governor **Carlin**. I think that's an excellent question. Certainly the question allows you, as you have, to limit the use. I think what we have found, quite frankly, is with the use of tax-exempt bonds we've been able in areas where it is difficult to attract, where you need some additional incentive, you have something to offer. And, therefore, it has been helpful. And you mentioned Satern where we are competing nationally. No, I can't justify or back up that particular purpose.

Our concern this morning, of course, in terms of tax reform is the municipal—the public purpose, the elimination of that or for all practical purposes the elimination with the rule that's being suggested by the President's program.

The **Chairman**. One of the frustrations is the amorphous definition of public purpose. And the New Jersey development director would say the providing of jobs is a public purpose.

Governor **Carlin**. And I think he's correct in terms of philosophy, but it can bee carried—it was abused. I mean I have to acknowledge that. And, therefore, you were right in taking some action. But I would suggest, as I did before, you have taken that action, and I would like to see some time pass to see how under that change it works before we come back now again with another significant, dramatic reduction.

The **Chairman**. Governor Lamm.

Governor **Lamm**. Mr. Chairman, your reform is already in this area, and I think that you are absolutely right. You can't leave it to State and local governments totally to define public purpose. I wish you could, but I do not think you can. The record of abuse is clear.

I do believe that you have already——

The **Chairman**. We have taken a number of steps already.

Governor **Lamm**. And, in fact, as I recall, they don't even take effect until, what, July 1, 1986. You have already gone part or all the way to solving the problems. And I think Governor Carlin is right. Wait to see what you have already done, because I think you have closed an awful lot of the abuse in this area.

We do have some specific policy on this. It talks about perhaps defining the sizes of business, defining the size of the distressed area that this should be available. We could make it a separate part of the record.

The CHAIRMAN. Governor Thornburgh.

Governor THORNBURGH. It's very hard to tell from the present status of the proposals that you are examining precisely what that public purpose definition is going to be. And the fact that you are dealing in a complicated area, I think, compounds the problem in terms of making an assessment as to what kind of a break point you have to have. Why 1 percent, for example. There might be some room for movement there.

As I said, these are very useful tools that all of us use in various—in what we define as public purpose areas. I think one observation that has been made that I think is worthy of some consideration is if these are such public purposes, why do you have to filter them through the bond market? Why don't you just establish various mechanisms that make these available for what there is a general consensus about public purpose rather than making them available simply to those who are buying and selling municipal bonds or tax-free industrial development bonds.

But the fact of the matter is, as I have reiterated my position, I think that if everything is going to be on the table and our overall effort is to simplify and reduce the tax burden on the taxpayers, this ought to be on the table as well.

The CHAIRMAN. A quick question to the two Governors who are on the opposite from you. There is just a little hint in your testimony of room for some compromise. Do you have any desire to sugget what that might be?

Governor CARLIN. Well, you heard from one of your colleagues this morning, and I would throw that out as an example of what we are talking about because it allows the deductibility issue to contribute what we would consider a fairer portion of the need to accomplish your overall mission, but still protects the thrust of federalism and the original purpose of deductibility.

Another specific suggestion is, say, to allow 80 percent of the deduction. You tally up all your State and local taxes and 80 percent of it can be deducted. That would likewise allow you to raise some needed revenue to balance off the package, but it would be certainly much fairer.

Senator, may I comment in terms of Governor Thornburgh in regard to the fairness aspect that we are protecting certain people on the deductibility issue. The fact is more people use the State and local tax deduction than anyone else. I mean you have a long list of other tax expenditures that are for a very narrow percent of the population. And if you want to use that argument, then I think it's, in fact, on the side of maintaining deductibility; not going after it.

And one other comment I would add is that we should be thinking about this together on both the bond issue and the deductibility issue. We really serve the same constituency. You are, and I think rightfully so, sending us more responsibility, but at the same time by reducing our use of bonds or by reducing or eliminating deductibility you also, I think we can agree, make it more difficult for us to accomplish those responsibilities you are handing us back.

The CHAIRMAN. Does that answer speak for you, too, Dick, or not?

Governor **Lamm**. Mr. Chairman, we have no policy on this so we are really testifying only for ourselves. But there are compromises, and I think along that line, perhaps add up all your State and local taxes and be able to deduct 75 percent of them. There are compromises out there. Senator Durenberger's approach. Something out there will work.

The **Chairman**. Thank you.

Senator Bradley.

Senator **Bradley**. Mr. Chairman, thank you very much.

Let me thank Senator Javits for his kind remarks about the Bradley-Gephart bill and for recognizing that it does not eliminate the deduction for State and local income taxes. I don't think it's a good idea to eliminate the deduction for State and local income taxes and property taxes.

But the question is really one that Senator Packwood asked. And that is, we are in a political process. It is conceivable that there will be a compromise at some point. And the thing that strikes me is that witness after witness comes in with an extreme position, argues the extreme position, offers the committee no counsel whatsoever as to what happens if we get into a mode, which is the usual mode in Congress, of some kind of compromise. And, therefore, I would urge you to try to be as forthright as you can at least about the principles that we should look at if we move toward some compromise on this issue.

I would assume that one of the principles that you would support is that the compromise should be as fair as possible, meaning that it should not benefit upper income individuals more than middle or lower income individuals. Is that not right?

Governor **Carlin**. Yes.

Senator **Bradley**. There are a couple of ideas around. Let's take your figures, Governor Lamm and Governor Carlin, as to who takes these deductions. You point out that 40 percent of the taxpayers take the deduction. You point out that 50 percent of those who take the deduction are under $30,000 in income. You point out that 13 percent of the taxpayers who take the deduction or about 6 percent of the taxpayers are over $50,000.

Let's assume that we kept the deduction for everyone; that we didn't eliminate it. But for that 6 percent of the population or maybe 10 or 15 percent of the upper income individuals, that that deduction was worth slightly less. Is that a reasonable compromise from the standpoint of the progressivity of the tax system and fairness?

Governor **Carlin**. We can't speak for the association because that specific question has not been put to the association. As an individual Governor, I would answer yes.

Senator **Bradley**. Governor Lamm.

Governor **Lamm**. Senator, I'm sorry in mentioning compromise I didn't mention your bill. I give you an unqualified yes to your question.

Senator **Bradley**. Governor Thornburgh.

Governor **Thornburgh**. I have a little trouble with that, Senator, because it seems to me what is unfair is the present system, and that the proposal that the President has made, which would be a benefit to all taxpayers in all States, is far more fair than the present system, which provides benefits only to high bracket taxpayers in high tax States. QED. It seems to me that if you are talking about making something more fair, you have a pretty tought road to hoe.

Senator **BRADLEY**. So you want to eliminate it, and you don't want to have any compromise?

Governor **THORNBURGH**. From the point of view of fairness to the taxpayer, it seems to me that the substitution of benefits to everyone is preferable to the retention of benefits for some.

Senator **BRADLEY**. All right.

Let me ask you as Governors. If we got a major tax reform bill passed, say it's the President's, say it's whatever, a variation of that, it is likely that you might have more revenue. Take your States. Are your codes tied to the Federal Code?

Governor **LAMM**. Thirty-five States in some form or another are tied.

Senator **BRADLEY**. Thirty-five are tied. Which means that adjusted gross income for those States would increase after tax reform because any change in the Federal Code would be reflected the State code. That would increase adjusted gross income in your States. So let's say adjusted gross income was $100 billion before tax reform. After tax reform let's say it's $150 billion. What would you do with that extra revenue? Would you cut your State tax rate possibly? You'd have the same amount of revenue.

Governor **CARLIN**. OK. First of all, let me add that the position that we've take on tax rform has not been based on short-term benefits. To those of us serving current terms, we are well aware that the bulk of us would get a little more revenue and it would not be a serious problem. We have our policy position on the base that it was right for the country the long haul and the principles we discussed here this morning.

In terms of what we would do with the revenue, yes, I would imagine we would get—I think it's pretty safe to say that we would get additional revenue in Kansas. I think you would have to look at that in light of two other things; principally, what you have done on the budget, what you probably will have cut; we will have more programs to make up. And, second, in our State with the deficit issue continuing, our economy is suffering, our revenues are going down. And so we would certainly, definitely not be talking about a tax break. I can guarantee you that.

Senator **BRADLEY**. Governor Lamm.

Governor **LAMM**. I would stick with that answer.

Senator **BRADLEY**. Governor Thornburgh, since you don't have that benefit, I won't ask you to answer that question.

Thank you very much, Mr. Chairman.

The **CHAIRMAN**. Senator Symms.

Senator **SYMMS**. Thank you, Mr. Chairman. And thank you, all three of the Governors, for your appearance here this morning. I have found it very enlightening.

I want to ask two questions. The first question will be, I think, one you can answer yes or no. I will cite a situation that is taking place in my state. I think Governor Lamm might have a similar situation with respect tok the mining industry. It's flat on its back. The forest-products, wood-processing industry is hurting. Agriculture is under a lot of pressure. A lot of these things are commodities that are internationally traded, and we are in a very competitive environment. The big deficit causes a stronger dollar, or it contributes to it in a way. For example, you are Governors trying to run the affairs of your States. What is your advice to us? Now I am a Senator from a State in which, just yesterday, Polax Corp. announced that they were closing their wood-processing operations in Idaho. These operations amount to about 1,000 jobs. About 600 of them come from a small community of 4,000 people. It's an unmitigated traumatic tragedy for those families. What's the most important? To worry about tax reform which has no impct on those people or to address ourselves to budgetary control and expenditure control?

I will just go down the list.

Governor CARLIN. I would say on behalf of myself—and I would almost guarantee the bulk of the Governors—the budget is the No. 1 problem. If you have got to pick and choose and you have only got time to take care of one, deal with the defict.

Governor LAMM. I think the deficit problem so overwhelms this problem. It just overwhelms it.

Governor THORNBURGH. I think that's true.

Senator SYMMS. Even though you made a very good statement, Governor, in favor of tax reform, you still think deficit spending is more important.

Governor THORNBURGH. The short-term problem of $200 billion deficit stretching as far as the eye can see is pretty chilling. I think there is a longstanding dissatisfaction with the perception of unfairness and inequity in our Federal tax system which cannot be ignored in perpetuity. But if it's an order of priority, I think getting ahold of that deficit and bringing those spending rates down has got to be a priority.

Senator SYMMS. Well, Governor, you bring me to my second question. I have long believed that we need tax reform, and I in general support the President's noble effort to simplify the tax bill, although I don't see his bill as being anywhere near what his speeches are. I like the speeches, but the bill looks like it was written by a bunch of people that don't believe in doing a lot of things, when you start looking at all the deductions they want to remove.

We have a basic bias in our Tax Code. I think we all agree that we double tax equity capital, that is, dividends. We tax interest savings accounts. Then we allow the deduction on interest expenditures. So we have a built-in bias in our Tax Code that is overwhelming in favor of consumption and in opposition to savings. It has grown over the last 40 years to that degree.

How do you think we can really have any tax reform that means anything unless we start in on the biggest single bias in the tax system and address that first, and then work back from that? In other words, what I'm saying is if we are going to do tax reform, why don't throw out all deductions and tax all income once and not have this hodgepodge.

These bills—administration's bill, the Bradley bill, and the Kemp bill—I guess the Kemp bill wouldn't because he has now left the resources alone—raise taxes on agriculture, mining, timber and recreation homes. These are the only bright spots in our economy.

It appears to me that there can't be much enthusiasm for this effort.

If we are not really going to have tax reform—in other words, not really going to stop double taxing savings, why is this exercise worthwhile?

Governor THORNBURGH. I hope I'm not misunderstood, Senator, but I would rather look at the proposal than the speech in that regard. I think if you are looking at a specific proposal with respect to some substitue for what the President——

Senator SYMMS. Well, the Hall-Rabushka tax plan from the Hoover Institute—Senator DeConcini has introduced it and I have cosponsored it to get it on the table—starts on that premise. It is really tax reform. It is a flat tax. It's based on a 19-percent tax rate, and it only taxes income once. But that would be a starting point.

Governor THORNBURGH. We have such a tax in Pennsylvania. As I indicated, ours is a flat tax, no deductions, simle, and it is one I think has a good deal of credibility with the populace. Obviously, with the revenue-raising capability that exists at the Federal level and the different needs that have to be met on a national basis, I wouldn't necessarily recommend that. But I think what the President has offered in terms of the gradations of tax rates that retain the progressivity features but bring all the rates down certainly has a lot to recommend it over what we have at the present time.

So much of what we are talking about here seems to me is not drafting and passing a perfect tax bill. With all of your skills and talent and all the time that you all, with your experience, devote to this, that's just not possible.

My view is—is what the President has proposed better than what we have today? And my answer is a resounding yes. And, therefore, I would urge you to make that incremental change and save the desire for perfection or at least defer the desire for perfection to another day.

Senator SYMMS. Could you say whether you think it's better than what we have or not, Governor Lamm and Governor Carlin?

Governor LAMM. Senator, I really feel that your question is an important one. I think you ought to look at each and every deduction. To me, this is not a rubber stamp body. You should judicially examine every deduction in the Tax Code. You were elected to do your own independent examination. When you talk about unraveling, I think there ought to be a presumption, let's say, against every deduction that you have. And then you examine it. And it's only if there is public policy reasons so overwhelming that you put them back in the Code. But I think State and local deductibility for oil drilling, for foreign tax credit, for a number of other things that are in the Code.

I think you are on the right track. Look skeptically at every deduction. Make it carry its own weight.

Governor CARLIN. But the efficiency issue that you raised, it is one that should be looked at because Governor Lamm in his remarks, I think, very specifically pointed out the differences between the deductibility issue versus some of the other tax expenditures. As far as what you have raised, I would stick with the current over the President's proposal for the very simple reason that I think if you are going to do it, I think you ought to do it right. And I think he has some fundamental flaws. You don't have just two choices. You can do it better. And so until you can do it better than the President, just stay with the current system.

Senator SYMMS. Thank you, Mr. Chairman.

The CHAIRMAN. Any other questions of this panel? We have others to go.

[No response.]

The CHAIRMAN. If not——

Senator MOYNIHAN. We certainly want to express our appreciation.

The CHAIRMAN. I was going to say, Governors, you did an excellent job. Thank you very much and thanks for being patient.

Next we are going to take very briefly——

Senator SYMMS. And we'll welcome you all to Boise next week.

The CHAIRMAN. Next is Ron Pearlman, the Assistant Secretary for Tax Policy. I asked him to come back although the administration has already testified on the entire tax bill. I asked him to come back to testify on this subject and then to be here when the next panel speaks, and the next panel represents quite a variety of local government interests, most of whom have some misgivings about this provision.

Mr. Secretary, the Governors were admirably brief in their presentations and we would hope in the spirit of federalism that you would follow their advice. [Laughter.]

Mr. PEARLMAN. Absolutely, Mr. Chairman. How can I not?

STATEMENT OF HON. RONALD A. PEARLMAN, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. PEARLMAN. I'm happy to be invited back. I don't really feel coming to the Finance Committee is coming back. And I am going to try to be brief.

I think it is important for us to be here this morning, and I do appreciate the chance of doing that.

I hope you will agree with me that it is less important for us to rehash what has been said a number of times before, and, instead, try to focus on some of the issues that are being debated at this point in the debate. And that's what I would like to do in the few minutes I have for my oral statement.

We have given you a written statement which does try to specifically deal with a number of the arguments that are being made in the press and before you, and some data that I think may be of assistance to you.

I'm going to focus on a couple of specific criticisms, but before doing so, I think it is important to go back, as we have so many times before, to what we consider, what I consider, is the principal reason for proposing the repeal of the deduction for State and local taxes. And that is an issue of fairness, and it's an issue of fairness in the context of a Federal tax system.

We begin with the simple fact that States and localities vary significantly in the type and the extent of public services that they choose to make, and thus the level of taxes that they impose. Because of the deduction differences in the level of taxes imposed by State and local governments translate to differences in the level of Federal income taxes paid by the residents of a particular jurisdiction, the deduction must leave State and local governments with the ability to effect the Federal income tax liabilities of their residents through their own tax and spending policies. The net effect, the deduction causes a shift in Federal income tax burdens to taxpayers in high-service, high-tax communities benefitting at the expense of taxpayers in low-service, low-tax communities.

To put it in other terms, because of the deduction to itemizing taxpayers with equivalent incomes living in different communities with different levels of State and local taxes, they will pay correspondingly different shares of the cost of national defense, interest on the national debt, other Federal programs. And we believe that's patently unfair, and we believe that is the fundamental reason why the issue of the deductibility of State and local taxes simply has to be a major issue in the tax return debate.

I would like to also just briefly comment—the data is contained more specifically in the statement—on the argument that we are hearing regularly now that this is a deduction of the middle class. I think we have to go back and begin by reminding ourselves that the vast majority of people in this country, taxpayers, do not itemize, and that, therefore, the deductibility of state and local taxes don't affect them at all. But, further, even when looking at itemizing taxpayers, even though a relatively large percentage of returns claim the deduction for State and local taxes, including 62 percent of the returns with an adjusted gross income between $25,000 and $30,000. Incidentally, that's in table 2, if you are interested in looking at it.

The simple fact is that the amount and value of the deduction reflects a disproportionate use by high-income taxpayers. Thus, as we show in table 3, roughly 75 percent of all tax returns in 1983 had adjusted gross income of less than $30,000—75 percent.

However, this same group of taxpayers accounted for only 28 percent of the total deductions taken for State and local taxes paid, and only 15 percent of the tax benefits from the deduction. Put another way, the top 25 percent of all taxable returns by adjusted gross income account for 85 percent of the total benefit of the taxes paid.

As Governor Thornburgh, I think, quite eloquently said, in evaluating the deductibility of State and local taxes, once again this data, I think, brings us back to an issue of fairness.

Now, I would like to move from that and focus very briefly on two arguments, again, that we hear made very frequently. And one of them is this very amorphous argument about federalism and the intrusion that a proposal to change the deductibility of State and local taxes has on essential relationships between the Federal Government and State and local governments.

Let me begin by saying that the process of examining the deductibility of State and local taxes is not new with the President's proposals. Indeed, if you go back—and we have put some data in the statement—if you go back and look at the history of the deductibility of State and local taxes, it is quite accurate that it was contained in both the Civil War income tax and in the 1913 income tax. But what has happened since that point is a periodic erosion of the deductibility of state and local taxes in the Federal tax system. And so what we see starting in the 1930's and going all the way up as late as 1978, I think it is, is specific decisions by the Congress to cut back the deductibility of State and local taxes. We had inheritance taxes. We had a variety of other taxes. Gas taxes. All were deductible at some point in time. And they are now no longer deductible. So we begin with not just sort of a new item where all of a sudden the administration is suggesting a repeal of the deductibility of State and local taxes, but really a maturation of a process that has been going on for a long, long time in this country.

Second, in articulating the federalism argument, I would submit to you that the proponents of that argument—that we are in some way disturbing the relationship between the Federal Government and State and local governments confuse federally coordinated programs, whether they are tax expenditures or whether they are direct expenditure programs that try to distribute the benefits of those programs across the Nation with a locally controlled subsidy. I use the word "subsidy" not to be pompous, Senator Moynihan. With a locally controlled subsidy for locally determined purposes.

Imagine, if you will, a direct expenditure program where the state and local government has total freedom to determine not only the programs on which Federal funds are spent, but also the level of spending. Such a proposal, I would submit, would not be taken seriously by the Congress. That the Congress would not write a blank check to State and local governments for any programs they want to spend. And, indeed, the State and local tax deduction, I suggest, does precisely that.

I think federalism is really turned on its head if we define a system in which taxpayers in some States, low-tax States in the case of the State and local tax deduction, or localities within a State are required to finance programs the size and purpose of which are determined solely by taxpayers in other states.

Another one of the issues that we hear about, and that is the high-tax States put more into the system argument, or what we refer to as the "fiscal flow argument." It is our view that we should look at the quantum of expenditures that are made by a Federal Governmnet in a particular State and we should compare that with the tax receipts and other payments made by taxpayers in that State, and balance them. And what we will find frequently is that high-tax States come out on the short end of that formula.

I would suggest to you that that is a very dangerous analysis to make. We have spent a lot of time over the years analyzing fiscal flows and what you will find when yo do that—and I think what people do find as they do that—is that it is impossible to make that kind of analysis without making some very broad and crude assumptions. Let me give you a couple of simple examples.

There is the fact that there is an Air Force base in Colorado and that there are salaries paid to personnel on that Air Force base in Colorado and does it really mean that the only State which benefits from the location of that Air Force base is the State of Colorado? Does the fact that a ship used by the Navy is constructed in one State and therefore payments for the construction of that ship are made in that State mean that only that State benefits from that ship? On the other hand, does the fact that someone lives in one State and works in another mean that one State or the other should be credited with the Federal tax liability paid by that individual? Or for that matter, does the fact that corporate tax receipts are deposited in one State—should that State get the credit for the corporate tax receipts in working out a fiscal flow analysis?

So I would simply urge you that in analyzing his so-called fiscal flow argument that is being made that you be wary of the very dangerous assumptions, I think, on which those are premised.

Mr. Chairman, I'm going to stop with the red light. I'll be happy to try to entertain your questions.

The CHAIRMAN. Thank you, Mr. Secretary.

[The prepared written statement of Mr. Pearlman follows:]

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STATEMENT OF RONALD A. PEARLMAN
ASSISTANT SECRETARY
(TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss the treatment under the Federal income tax system of amounts paid for State and local taxes. As you know, the President's tax reform proposal would generally repeal the existing itemized deduction for State and local taxes.

Introduction

Current Law

Section 164 of the Internal Revenue Code allows taxpayers that itemize deductions to deduct four types of State and local taxes that are not incurred in a trade or business or income-seeking activity: individual income taxes, real property taxes, personal property taxes, and general sales taxes. Other State and local taxes are deductible by individuals only if they are incurred in carrying on a trade or business or income-seeking activity. This category includes taxes on gasoline, cigarettes, tobacco, alcoholic beverages, admission taxes, occupancy taxes and other miscellaneous taxes.

Taxes incurred in carrying on a trade or business or which are attributable to property held for production of rents or royalties (but not other income-producing property) are deductible in determining adjusted gross income. Thus, these taxes are deductible by both itemizing and nonitemizing taxpayers. Taxes incurred in carrying on other income-seeking activities are deductible only by individuals who itemize deductions. Examples of these taxes include real property taxes on vacant land held for investment and intangible personal property taxes on stocks and bonds. State and local income taxes are not treated as incurred in carrying on a trade or business or as attributable to property held for the production of rents or royalties, and therefore are deductible only by individuals who itemize deductions.

Administration Proposal

Under the President's Tax Proposals to Congress for Fairness, Growth, and Simplicity, the itemized deduction for State and local income taxes and other taxes not incurred in carrying on a trade or business or income-seeking activity would be repealed. State and local taxes (other than income taxes) which currently are an itemized deduction but which are incurred in carrying on an income-seeking activity would be aggregated with certain other miscellaneous expenses and would be deductible above a threshhold of one percent of adjusted gross income.

State and local taxes that under current law are deductible without regard to whether the taxpayer itemizes would not be affected by the proposal. Thus, for example, real property taxes on property used in a trade or business or held for rental would remain deductible. Similarly, the proposal would not affect the deductibility of State and local taxes paid by corporations.

Reasons for Proposed Repeal

Fairness

Analysis of the deduction for State and local taxes appropriately begins with the question of its fairness in the context of the Federal income tax system. The question of fairness is, in turn, driven by the fact that States and localities vary significantly in the type and extent of public services which they choose to provide and thus in the level of State and local taxes they impose. Because of the deduction, differences in the level of taxes imposed by State and local governments translate to differences in the level of Federal income taxes paid by the residents of particular jurisdictions. The deduction thus leaves State and local governments with the ability to affect the Federal income tax liabilities of their residents through their own tax and spending policies. In net effect, the deduction causes a shift in Federal income tax burdens, with taxpayers in high-service, high-tax communities benefitting at the expense of taxpayers in low-service, low-tax communities. Put in other terms, because of the deduction, two itemizing taxpayers with equivalent incomes living in communities with different levels of State and local taxes will pay correspondingly different shares of the cost of national defense, interest on the national debt and other Federal programs. This result is patently unfair.

The unfair distribution of benefits among State and local jurisdictions as a result of the deduction for State and local taxes is illustrated by recent tax return data. As shown in Table 1, tax savings per capita in 1982 as a result of the deduction varied widely among the States, ranging from a high of $233 for New York to $20 for South Dakota. The discrepancies are even greater when the tax savings accruing to itemizers are compared. For example, in 1982, itemizing taxpayers in New York received an average tax savings of $1,292 from the deduction, whereas itemizers in Wyoming on average saved only $257.

Although the data in Table 1 focus on the distribution of the deduction's benefit among the States, it is important to recognize that the question of fairness is not simply a matter of high-tax versus low-tax States, but equally of high-tax versus low-tax communities within the same State. Thus, the deduction is of greater benefit to an affluent suburb with high property taxes, a population of high-income, itemizing taxpayers, and a high level of home ownership, than to a not far distant inner city community, where renters predominate and few itemize their deductions.

Tax return data also contradict those who argue that the deduction for State and local taxes is a "middle class deduction." Although a relatively large percentage of returns claim a deduction for State and local taxes, including 62% of taxable returns with AGI of between $25,000 and $30,000 (Table 2), the amount and value of the deduction reflects disproportionate use by high-income taxpayers. Thus, as shown in Table 3, roughly 75 percent of all taxable returns in 1983 had AGI of less than $30,000; however, this same group of returns accounted for only 28 percent of the total deductions taken for State and local taxes paid, and only 15 percent of the tax benefits from the deduction. Put another way, the top 25 percent of all taxable returns by AGI account for 85 percent of the total benefit from the taxes paid deduction.

A final issue of fairness concerns the effect of the deduction on State and local tax burdens within particular communities. Consider the variation in effective tax rates for three persons facing a 6 percent State sales tax: a nonitemizer, an itemizer in the 20 percent tax bracket, and an itemizer in the 50 percent bracket. The nonitemizer pays the full 6 percent sales tax rate, whereas the two itemizers pay effective rates of 4.8 and 3 percent, respectively. Thus, a State and local tax that is flat or even mildly progressive in form, is transformed by the deduction to one that is significantly regressive in effect.

Need to Reduce Marginal Rates

Aside from the issue of fairness, the revenues at stake with respect to the State and local tax deduction are critically important to our efforts to reduce marginal tax rates. Under current law, the deduction for State and local taxes is projected to result in a revenue loss of approximately $33 billion in 1987, increasing to $40 billion by 1990. Unless these revenues are recaptured through a repeal of the State and local tax deduction, a significant reduction in marginal rates will not be possible within the constraint of revenue neutrality. We should not lose sight of the fact that lower tax rates are central to tax reform, and that lower rates will, in and of themselves, do much to reduce the significance of tax considerations in personal and commercial decision-making and therefore to promote fairness, growth, and simplicity.

Inefficient Subsidy

Many who support the deduction for State and local taxes concede that it cannot be defended as a matter of tax policy, but argue instead that it is an appropriate subsidy for State and local government spending. Even assuming a Federal subsidy for State and local spending is appropriate, a subsidy provided through a deduction for State and local taxes fails on grounds both of efficiency and fairness. On average, State and local governments gain less than 50 cents for every dollar of Federal revenue loss because of the deduction. Moreover, a deduction for taxes does not distinguish between categories of State and local spending, but is as much a subsidy for spending on recreational facilities as for public welfare spending. The deduction thus operates as a general subsidy for State and local government spending, with the result that high-service, high-tax States and localities derive a disproportionate benefit.

Effect of Repeal on States and Localities

Effect on Spending

Many of the arguments for retention of the deduction for State and local taxes reflect concern over the effect of repeal on the ability of States and localities to raise necessary revenue. These concerns are understandable, but a hard look at the facts indicates that the effect of repeal on State and local spending will be extremely modest. Perhaps the most important fact to consider is that a relatively small percentage of State and local expenditures are financed with deductible taxes. As shown in Table 4, taxes claimed as an itemized deduction represent about 31 percent of all State and local tax revenues, and only 20 percent of all State and local revenue sources exclusive of borrowings.

Even as to State and local revenues derived from deductible taxes, the effect of repeal should be limited. Since the President's proposals are revenue neutral, State and local governments will face no greater competition with the Federal government for tax dollars. Indeed, among individuals, the only taxpayers affected by repeal of the State and local tax deduction, the President's proposals reduce Federal income taxes, and thus leave even greater flexibility to State and local governments. In addition, the other base-broadening provisions contained in the Administration proposal will actually tend to increase tax revenue for the thirty-two States (and the District of Columbia) with income tax systems that utilize Federal concepts of taxable income. For example, Colorado recently estimated that, unless it lowered its income tax rates, 1986 tax revenues would be increased by $50 million as a result of the base-broadening contained in the Administration proposal. The proposed base-broadening will also benefit States that impose corporate income taxes that "piggyback" on Federal definitions of taxable income.

Our conclusion that repeal of the State and local tax deduction will have a very limited effect on State and local spending is confirmed by recent independent studies. Thus, a National League of Cities study found that total State and local spending is about two percent higher because of the existence of the deduction for State and local taxes. Similarly, a study by the Congressional Research Service predicted that total State and local expenditures would be only 1.5 percent lower if the deduction were repealed. Assuming that the current seven percent annual growth rate in State and local spending continues, these studies indicate that repeal of the deduction would not reduce the level of State and local spending, but would merely slow its rate of growth. Moreover, both of the studies assumed that nonitemizers exert no control over State and local spending and tax decisions. If the role of nonitemizers in the electoral process were taken into account, the predicted effect of repeal on State and local spending would necessarily be lower, perhaps by a substantial amount. The figures from the studies, of course, represent averages, and thus the effect on particular States and localities could be higher or lower.

It must also be recognized that repeal of the State and local tax deduction will reduce State and local spending only to the extent taxpayers decide that the services provided by State and local governments are not worth the taxes paid to provide them. Moreover, to whatever extent State and local taxpayers make that decision, the practical effect is not a loss of wealth to State and local communities, but a shift in resources from public to private activities. Thus, any loss in State and local government spending would be matched by an increase either in private goods or services or in private investment and savings. Such increase would have positive effects on State and local economies, which should, in turn, generate additional tax revenue.

Some opponents of repeal have argued that, at a minimum, the property tax deduction should be retained because of its importance in financing education expenditures. The argument ignores that itemized property taxes, the only property taxes that would be affected by the proposal, constitute only a small percentage of the revenues supporting public education expenditures. Less than half of all State and local direct expenditures for elementary and secondary education are financed from property tax revenues. Moreover, less than 35% of all property taxes paid are claimed as an itemized deduction, with the balance either not deducted at all (because paid by non-itemizers) or deductible by corporations and other businesses and thus unaffected by repeal. Thus, less than 18% of all State and local direct expenditures for elementary and secondary education are financed by property taxes which are claimed as itemized deductions.

Effect on Interjurisdictional Tax Competition

Some opponents of repeal have argued that deductibility is necessary to mute tax competition among different jurisdictions, and that absent the deduction, State and local governments would bid destructively to attract taxpayers to their jurisdictions. Such fears about the adverse effects of tax competition are greatly overstated. Competition among business firms is universally heralded as the source of efficiency, innovation, and cost control; without it, consumers are at the mercy of those who enjoy monopoly positions. The same line of reasoning is applicable to competition among the States and among localities. As long as the Federal government mutes competition by picking up part of the tab for State and local expenditures, there is less need for responsive and responsible government. Competition can be expected to bring more innovative government, greater efficiency, and lower cost than a system in which State and local governments operate under the umbrella of Federal deductibility.

It should also be noted that taxes are but one element in the competition among jurisdictions. Jurisdictions that impose high taxes also deliver a high level of services. The choice faced by taxpayers is not simply whether to live in a high-tax or low-tax jurisdiction, but also whether to live in a jurisdiction with high or a low level of public services. Moreover, for the clear majority of taxpayers, those that do not itemize deductions, tax deductibility does not affect interjurisdictional tax differences.

Response to Arguments Against Repeal

Opponents of repeal of the deduction for State and local taxes have advanced a number of arguments in support of their position. We believe these arguments are without substance, and I would like to take this opportunity to respond to them.

1. "The Administration proposes repeal simply for the money." It has been asserted that the Administration proposes repeal of the State and local tax deduction simply "for the money." The assertion is not only untrue, it is disingenuous. Even a casual study of the academic literature would reveal that

economists and legal scholars have for years criticized the deduction for State and local taxes, and cited its repeal as an important element of tax reform. Similarly, the two leading tax reform proposals originated in Congress, one sponsored by Republicans and the other by Democrats, would each substantially restrict the State and local tax deduction. What these and other studies of tax reform have recognized is that the deduction for State and local taxes fails the basic test of fairness.

2. "The deduction is part of federalism." Some have argued that the disproportionate benefits provided to high-tax States by the deduction for State and local taxes are no different than the wide variety of direct benefits that the Federal government provides to State and local communities. On this view, the State and local tax deduction is akin to crop support, disaster relief, water and mass transit projects, and the other assorted Federal programs and benefits that are targetted to particular communities. Although this argument purports to draw on principles of federalism, it, in fact, confuses Federally coordinated programs that distribute benefits across the nation with a locally controlled subsidy for locally determined purposes. Imagine the response in Congress to a proposed Federal spending program under which State and local governments, each acting independent of the other as well as of the Federal government, were free to determine not only the programs on which funds were to be spent, but more critically, the actual level of spending. Such a proposal would surely not be taken seriously, and yet that is the precise effect of the deduction for State and local taxes. Unlike crop support, disaster relief and the other Federal projects that are annually reviewed and approved by Congress, the subsidy provided by the State and local tax deduction is controlled in both amount and character by the individual policies of countless State and local governments. Federalism is turned on its head if defined as a system under which taxpayers in low-tax States and localities are required to finance programs the size and purpose of which is determined solely by the taxpayers of high-tax States and localities.

3. "High-tax States put more into the Federal system than they get out." Some who defend the State and local tax deduction argue that even though high-tax States are disproportionately benefitted by the deduction, they nevertheless pay more on average to the Federal treasury in taxes than they receive in Federal outlays. Thus, so the argument goes, high-tax States are subsidizing low-tax States, rather than the reverse. This sort of argument verges on the irresponsibile, for it draws on a mechanical analysis of where Federal expenditures are made to support a conclusion about which States benefit from the expenditures. Consider Federal expenditures for national defense. Does the fact that an air force base is located in Colorado mean that the salaries of personnel at the base benefit no State in the Union other than Colorado? Similarly, does the cost of the ships, planes, missiles and other equipment used by

the armed services represent a benefit only to the State in which they are built? The answer, of course, is no; the benefit of Federal expenditures for defense, as with the great bulk of Federal expenditures generally, extends far beyond the State in which the expenditures are made.

There are comparable difficulties in allocating Federal tax receipts to particular States. Many individuals, particularly in the urban areas of the Northeast, work in one State but live in another. Which State should be credited with their tax payments? How, moreover, are corporate tax payments to be allocated among the States? Should they be treated as effectively paid by the corporation's customers, by its employees, by its shareholders, by all owners of capital, or by some combination thereof? The fact is that all of the published studies that have attempted to analyze the source of Federal tax revenues have been forced to make grossly simplifying assumptions about these and other questions. They are a slender ground on which to base an argument that some States pay more to the Federal government than they receive in benefits.

4. "State and local taxes have been deductible since the inception of the income tax." Some opponents of repeal have cited the fact that a deduction for State and local taxes has been allowed historically, as though to suggest that deductibility of State and local taxes is an inviolable tenet of Federal-State relations. A careful reading of the deduction's history, however, suggests something quite different. Although the first Civil War Income Tax Act and the Revenue Act of 1913 each allowed a deduction for State and local taxes, they similarly allowed a deduction for Federal taxes, including the Federal income tax itself. Over time, Congress increasingly narrowed the range of deductible taxes: the deduction for Federal income taxes was eliminated in 1917; the deduction for Federal and State inheritance and transfer taxes was eliminated in 1934; the deduction for certain State and local sales, transfer and admission taxes was eliminated in 1964; and the deduction for non-business State gasoline taxes was eliminated in 1978. The successive restrictions on deductible State and local taxes contradict any notion that the current deduction rests on a bedrock principle of federalism. Moreover, the historical grounds on which certain State and local taxes have remained deductible are of limited relevance today. For example, Congress in 1964 indicated that continued deductibility of State income taxes was appropriate because the combined Federal and State tax rate could otherwise be excessively high. That judgment may have been correct at a time when the maximum Federal rate was 90 percent, but there is no comparable basis for concern at current rates. Indeed, the reduction in Federal income tax rates under the President's proposals would generally reduce the combined rate of tax on individual and business income.

It should also be recognized that the early Federal income tax statutes were written at a time when the relative powers and responsibilities of the Federal and State governments were viewed much differently than today. In 1917, the Supreme Court was preparing to hold unconstitutional a Federal statute attempting to regulate child labor, Hammer v. Dagenhart, 247 U.S. 251 (1918), and was still decades away from recognizing Federal powers and responsibilities that are taken for granted today. This limited, and long since outmoded view of Federal authority carried over to the tax laws, where Congress originally allowed not only a deduction for State and local taxes, but also a complete exemption from tax for the salaries of State and local government employees. In time, it was recognized that whether State and local employees should pay Federal income tax was a question of tax and social policy, and not of Federal versus State authority. We believe the debate over the deductibility of State and local taxes should be conducted on the same terms, and that on those terms, the deduction is revealed as an anachronism that should be ended.

5. "Tax reform should not be accomplished on the backs of States and localities." Some opponents of repeal have asserted that the State and local tax deduction has been unfairly singled out in the Administration's proposal. Thus, they claim that the revenue loss from the State and local tax deduction constitutes only 11 percent of the revenue loss from all "loopholes" in the system (as measured by the tax expenditure budget), but 67 percent of the revenue necessary to lower marginal rates under the Administration proposal. At the outset, we would note that the figure of 67 percent was apparently derived by dividing the $33.3 billion revenue pickup from repeal of deductibility in fiscal year 1987 by the $49.5 billion revenue loss from the proposed change in the rate schedule in the same year. This analysis overlooks the fact that the increase in the zero bracket amount and the increase in the personal exemption are integral parts of the rate reduction provided in the President's proposals. When these items are considered, the revenue generated by repeal of the State and local tax deduction constitutes about 35 percent of the revenue necessary to revise the rate structure in fiscal year 1987 and about 31 percent in fiscal year 1990.

We recognize that absent repeal or reduction of every preference on the tax expenditure budget, those items that are repealed or reduced will inevitably generate a disproportionate share of the revenue necessary for rate reduction. This mathematical fact should not be permitted, however, to divert attention from the merits of particular preferences. In the context of fundamental tax reform, each preference must be tested separately for whether it is fair and in the national interest. We concluded, for example, that a deduction for charitable contributions should be retained, even though many would characterize it as a preference. The deduction for State and local taxes, however, should be judged on its own merits. If, as we have concluded, it is neither fair nor in the national interest, it should be repealed.

6. "Repeal of the State and local tax deduction would amount to imposing a tax on a tax." We believe this argument is more rhetorical than real. It is contradicted by the practice of most States with respect to their own tax systems: 43 States and the District of Columbia impose a personal income tax, yet 28 of these jurisdictions do not permit a deduction for Federal income tax, and many also allow no deduction for local taxes. Similarly, of the 46 States that impose a corporate income tax, 39 do not permit a deduction for Federal income taxes.

To the extent the "tax on a tax" argument has substance beyond its rhetoric, it suggests that amounts paid in state and local taxes should be exempt from Federal taxation because such payments are involuntary and because State and local taxpayers receive nothing in return for their payments. Neither suggestion is correct. State and local taxpayers receive important personal benefits in return for their taxes, such as public education, water and sewer services, and municipal garbage removal. Moreover, State and local taxpayers have ultimate control over the taxes they pay through the electoral process and through their ability to locate in jurisdictions with amenable tax and fiscal policies.

7. "It's unfair to permit a foreign tax credit but not a State and local tax deduction." The asserted analogy between foreign taxes and State and local taxes is unsound. The foreign tax credit is an integral part of a system of international taxation in which primary taxing authority is generally ceded to the country where income is earned. Under this system, U.S. residents are allowed a foreign tax credit for foreign taxes paid, just as foreign taxpayers earning income in the U.S. are generally allowed a credit in their home country for U.S. taxes paid. In contrast to this international system in which primary taxing authority is ceded to one country, our federal system of government necessarily involves different levels of government applying tax to the same taxpayers and the same income. The deductibility of taxes paid to overlapping domestic jurisdictions thus is not an issue of double taxation but rather of the extent to which each jurisdiction is able to define its own tax base. As indicated above, most States assert this authority for themselves by denying a deduction for Federal income taxes.

Conclusion

Let me say in closing that the nation faces an historic opportunity to reform the tax system, for the benefit of ourselves and of generations to come. By reducing marginal tax rates and improving the fairness of the system we can remove unnecessary restraints on the prosperity of all Americans. We believe repeal of the deduction for State and local taxes is a necessary component of tax reform. Let me emphasize again that this is not simply a question of revenue, but more fundamentally, a question of fairness. As has been eloquently stated by Governor Thornburgh "... what divides the nation is the unfairness of the present tax structure. If there's anything that demonstrates the unfairness of the deductibility of State and local taxes it's the fact that there's such an enormous difference in viewpoint depending on what State you're in .... When you have that kind of difference you've got an unfair tax system."

* * *

This concludes my prepared remarks. I would be happy to answer any questions that you might have at this time.

Table 1

States Ranked by Per Capita Tax Savings from Taxes Paid Deduction-- 1982

State	Tax Savings Per Capita	Income Per Capita	Rank of Income Per Capita
New York	$233	$12,314	7
District of Columbia	198	14,550	2
Maryland	185	12,238	9
New Jersey	167	13,089	4
Delaware	162	11,731	14
California	155	12,567	5
Massachusetts	155	12,088	11
Minnesota	150	11,175	19
Michigan	144	10,956	22
Wisconsin	137	10,774	26
Connecticut	135	13,748	3
Oregon	117	10,335	31
Hawaii	116	11,652	15
Rhode Island	116	10,723	28
Virginia	113	11,095	20
Colorado	110	12,302	8
U.S. Average	106	11,107	-
Illinois	101	12,100	10
Utah	91	8,875	46
Georgia	87	9,583	37
Nebraska	87	10,683	29
Oklahoma	89	11,370	18
Pennsylvania	83	10,955	23
Ohio	82	10,677	30
Kansas	80	11,765	13
North Carolina	77	10,044	41
Arizona	76	10,173	32
Iowa	75	10,791	25
Vermont	75	9,507	39
South Carolina	73	8,502	49
Maine	70	9,042	42
Missouri	70	10,170	34
New Hampshire	68	10,729	27
Kentucky	65	8,934	44
Idaho	64	9,029	43
Washington	63	11,560	16
Nevada	57	11,981	12
Indiana	51	10,021	35
Florida	50	10,978	21
Alabama	49	8,649	48
Arkansas	49	8,479	50
Alaska	45	16,257	1
Texas	43	11,419	17
North Dakota	42	10,872	24
Montana	41	9,580	38
Mississippi	39	7,778	51
New Mexico	38	9,190	40
West Virginia	34	8,769	47
Tennessee	33	8,906	45
Wyoming	33	12,372	6
Louisiana	31	10,231	32
South Dakota	29	9,666	36

Source: Advisory Commission on Intergovernmental Relations.

Table 2

Number and Percentage of Returns with Taxes Paid Deduction - 1983

Adjusted Gross Income Class	All Returns (thousands)	Taxable Returns (thousands)	Returns with Taxes Paid Deduction 1/ (thousands)	Returns with Taxes Paid Deduction 1/ as percent of All Returns	Returns with Taxes Paid Deduction 1/ as percent of Taxable Returns
Total	96,321	81,492	34,794	36.1%	42.7%
Under $ 5,000	17,836	5,801	538	3.0%	9.3%
$ 5,000 - $ 9,999	16,828	14,615	1,680	10.0%	11.5%
$ 10,000 - $ 14,999	13,878	13,523	2,621	18.9%	19.4%
$ 15,000 - $ 19,999	10,770	10,672	3,420	31.8%	32.0%
$ 20,000 - $ 24,999	8,849	8,802	4,166	47.1%	47.3%
$ 25,000 - $ 29,999	7,357	7,329	4,591	62.4%	62.6%
$ 30,000 - $ 39,999	10,421	10,389	8,140	78.1%	78.4%
$ 40,000 - $ 49,999	5,148	5,136	4,651	90.3%	90.6%
$ 50,000 - $ 74,999	3,591	3,582	3,393	94.5%	94.7%
$ 75,000 - $ 99,999	823	821	792	96.2%	96.5%
$ 100,000 - $ 199,999	622	620	607	97.6%	97.9%
$ 200,000 - $ 499,999	162	162	160	98.3%	98.5%
$ 500,000 - $ 999,999	25	25	25	98.6%	98.7%
$ 1,000,000 & over	11	11	11	98.5%	98.6%

Office of the Secretary of the Treasury
Office of Tax Analysis

July 23, 1985

1/ Taxes paid deduction net of State income tax refunds.

Note: Detail may not add to total because of rounding.

Source: Internal Revenue Service, Statistics of Income for 1983 individual income tax returns.

Table 3

Cumulative Percentages of Taxable Returns, Returns with Taxes Paid Deductions, Taxes Paid Deduction, and the Value of the Taxes Paid Deduction -- 1983

Adjusted Gross Income Class	Cumulative Percentages of:			
	Taxable Returns	Returns with Taxes Paid Deduction	Taxes Paid Deduction 1/	Value of Taxes Paid Deduction 2/
Under $ 5,000	7.12%	1.55%	.37%	**
Under $ 10,000	25.06%	6.38%	2.06%	.30%
Under $ 15,000	41.65%	13.91%	5.25%	1.43%
Under $ 20,000	54.75%	23.74%	10.45%	3.94%
Under $ 25,000	65.55%	35.71%	17.94%	8.27%
Under $ 30,000	74.54%	48.91%	28.04%	15.16%
Under $ 40,000	87.29%	72.30%	50.00%	33.17%
Under $ 50,000	93.59%	85.67%	66.00%	49.75%
Under $ 75,000	97.99%	95.42%	82.02%	70.14%
Under $ 100,000	99.00%	97.69%	87.41%	78.20%
Under $ 200,000	99.76%	99.44%	93.80%	88.93%
Under $ 500,000	99.96%	99.90%	97.18%	94.93%
Under $1,000,000	99.99%	99.97%	98.39%	97.11%
All Returns	100.00%	100.00%	100.00%	100.00%

Office of the Secretary of the Treasury
Office of Tax Analysis

July 24, 1985

1/ Taxes paid deduction net of State income tax refunds.

2/ The value of the deduction for taxes equals the marginal tax rate times the lesser of the deduction for taxes (net of State income tax refunds) or total itemized deductions (net of State income tax refunds) in excess of the zero bracket amount.

** Less than .005 percent.

Note: Detail may not add to total because of rounding.

Source: Internal Revenue Service, Statistics of Income for 1983 individual income tax returns.

Table 4

Taxes Paid Deductions as Percent of Total State and Local Government Receipts and Expenditures
Calendar Year 1982

	$billions
Total itemized taxes paid deduction	$ 88.0
Minus State income tax refunds	5.0
Total taxes paid deductions net of refunds	83.0
Total tax revenue of State and local governments 1/	270.9
-- Itemized taxes paid deductions as percent	30.6
Total State and local government expenditures from own source revenues 2/	325.2
-- Itemized taxes paid deductions as percent	25.5
Total State and local government receipts from own source revenues 3/	358.0
-- Itemized taxes paid deductions as percent	23.2
Total State and local government expenditures after intergovernmental transfers 4/	409.0
-- Itemized taxes paid deductions as percent	20.3

Office of the Secretary of the Treasury
Office of Tax Analysis

July 22, 1985

1/ Fiscal year data converted to calendar year with 3/4 for FY 82 and 1/4 for FY 83.

2/ Excludes the $81.6 billion of Federal aid to State and local governments.

3/ Includes interest earnings, user fees and miscellaneous charges.

4/ Federal aid to State and local governments spent by State and local governments as State and local expenditures.

Source: Statistics of Income Individual Income Tax Returns 1982; Advisory Commission on Intergovernmental Affairs, Significant Features of Fiscal Federalism, Tables 1, 2, 3, and 33.

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. Mr. Chairman, once again to welcome Secretary Pearlman whose openness, candor, and clarity, in these matters is appreciated.

Just one remark. And I know you will take it in the spirit in which it is intended. You referred to amorphous arguments about federalism. Well, there are those of us who take this matter very seriously. Indeed, the Senate embodies the role of the States in the Federal system, and our singular purpose here is to attend to the principles of federalism as we adduce them. A small volume called the "Federalist" was published in 1788 in my State in pursuit of these matters—we still read it, some of us here.

We make the point that federalism as devised in Philadelphia was not a managerial arrangement that considered the technology at the time owing to the fact we didn't have long distance telephones. [Laughter.]

It was a principle of Government, Ron.

I have two questions. One, very simply, straight out.

Mr. **Pearlman**. I get no opportunity, I guess, to make a comment on that one? [Laughter.]

Senator **Moynihan**. No.

Mr. **Pearlman**. I will write you a letter on it. [Laughter.]

Senator **Moynihan**. That was a statement.

Ron, I'm going to have to ask you this now. Get ready. On April 9, 1983 in a radio address from Camp David, President Reagan said as follows:

> A recent special report put out by the Democratic Study Group makes plain they are considering many other options to raise your taxes. You should know that these options include capping mortgage interest deductions and eliminating deductions for State and local taxes. In other words, you would pay a tax on a tax.

Now has the President changed his mind? And, if so, when? And, if so, who did it? [Laughter.]

Mr. **Pearlman**. I think there are two parts to your question. [Laughter.]

I think first if we were sitting here talking about—if we were not sitting here on a tax reform context, if we were sitting here talking about revenue raising and a proposal to eliminate the deductibility for state and local taxess, for home mortgage interest deductions, for investment credit, whatever, I think you would get a clearly different response from the President. I think that the issue here—I think well put by a couple of the Governors—is we are embarked on what, I think most people agree, is a bold effort at fundamental reform of the system. And it is in that context that the President is supportive of a repeal of State and local tax deductions.

Now you may have been asking has he changed his mind on tax on a tax. I can't answer that question. I don't know. I can tell you that we have said repeatedly that we do not believe that this is a tax on a tax issue. That on a very empirical basis, I think, that one may be able to document that by simply looking at what the vast majority of States do when they are asked whether the Federal tax, or indeed local taxes within their States, are deductible for State taxes. And most of them, as I presume you know, answer that question no.

Senator **Moynihan**. Ron, why don't you just admit that you know Treasury 1 is an exemplary product of a theory of taxation devised by the only policy planning staff at the Treasury and that the President had only the slightest idea of what they were doing while he was out getting himself reelected. Could I ask you one other thing? [Laughter.]

The OMB has for a number of years defined the loss of the tax revenue to the Federal Government from tax-exempt State bonds as a subsidy. You think it is a justified subsidy? Well, you defined this deduction of State and local taxes as a subsidy.

Mr. **Pearlman**. I think that's a difficult question to answer. I think in a pure system—and I will now go back to the debate with Treasury 1. In a pure system, I think clearly the exemptions, the tax exemptions, for State and local bonds should not be in a tax system. And I say that in an academic context. As a practical—on a practical basis—and that was our decision. I make that very explicit. On a practical basis, we believed that it was important to continue to let State and local governments use the tax exemption privilege as a financing technique, if limited. Now I recognize some have argued that, well, if you allow the State and local governments to use the tax exemption privilege as a financing technique, then why shouldn't you allow people to continue to take the deductibility for State and local taxes. I do think it is different.

Senator **Moynihan**. Well, my time is up, and I don't want to keep you. But may I just say honestly, that it offends the idea of federalism to describe something like this as a tax subsidy, something donated by the Federal Government to some subsidiaries called "States." You and I can't agree on that.

Mr. **Pearlman**. Let me——

Senator **Moynihan**. We would not——

Mr. **Pearlman**. Permit me, at least, to say this much, Mr. Chairman, Senator. I think one of the things that is very—continues to be unfortunate in this debate, and that is to use buzz words to pit people against each other. And the word "loophole" and "subsidy" tend to do that. We have tried not to do that. We have tried as best we can to articulate the merits. You and I may disagree on the merits, but it's not with the idea of trying to elevate the Federal Government to a level above the States. I think we all believe in federalism. And I hope the debate stays on that level.

Senator **Moynihan**. Thank you.

The **Chairman**. Senator Durenberger.

Senator **Durenberger**. Thank you.

Ron, when you came before the Intergovernmental Relations Subcommittee, you appeared as a tax expert, and today in front of this committee you are coming off as a federalism expert.

[Laughter.]

Senator **Durenberger**. I want to associate myself with the remarks of the distinguished Senator from New York regarding your definition of amorphous.

Two questions. And I guess we aren't going to agree on this. I'm just trying to figure out why you or the administration insist on it. And Dick Thornburgh did, too. There I am quoting from your statement.

Put another way: "The top 25 percent of all taxable returns by adjusted gross income account for 85 percent of the total benefit from the taxes paid, deduction." And the implication is that is totally unfair.

My point—when Dick Thornburgh made that point—was that those are the people who are paying the taxes for which they get relatively few benefits; particularly at the State and local level, except, perhaps, education benefits. They are the ones who are paying the larger share of the taxes, and a lot of other people down below them are getting the larger share of the benefits.

Now, I could see you're making that argument if we were talking about the interest deduction where only the taxpayer benefits, or some other deduction where only the taxpayer benefits and you have to sort of stretch it to cover some other things in the community. But, when you are talking about taxes—as the President said, the tax on the taxpayer—which are going to benefit, in greater proportion, somebody else in the community; what makes that unfair? What makes that unfair?

Mr. **Pearlman**. Well, let me suggest this, Senator: The way you put the question implies there is a correlation, there is a direct correlation, between the income level and the amount of taxes paid, and, therefore, the deductibility attracts that. But the facts are simply not those.

Let me just give you one example. Something like 63 percent of the families in this counry are homeowners. Over half of the homeowners in the country who obviously pay property taxes don't itemize for Federal income tax purposes. The problem we get into is that there is not a correlation between the tax burden and the benefit that one receives through a tax deduction. And as a result of that, it's not unique to the State and local tax deduction, as you point out. It's true with other deductions, but it's also true at the State and local tax deduction that it varies, it depends, on what kind of tax you are talking about, what the incidence of that tax is, and you don't find an absolute correlation.

Senator **Durenberger**. But the whole thrust of the administration argument is: It is unfair that people in higher income brackets are getting some kind of benefit.

Mr. **Pearlman**. That is absolutely right. What we are saying is that simply because a taxpayer is in a higher income tax bracket does not mean that he is paying relatively more taxes than someone else. It simply means at a higher income level the dollar amount of his benefit is greater than lower income taxpayers, and one of the problems is the itemizer, the nonitemizer distinction.

Senator **Durenberger**. And I knew we wouldn't agree.

[Laughter.]

Senator **Durenberger**. Let me get to the other question before the mayors get up because—I wish you had tried to be a federalism expert at the other hearing and a tax expert here. But this is the other quotation:

> Put in other terms, because of the deduction, two itemizing taxpayers with equivalent incomes living in communities with different levels of state and local taxes will pay correspondingly different shares of the cost of national defense, interest on national debt and other federal programs. This result is patently unfair.

And that theme appears throughout the administration's testimony. And I just have to say I find that to be patently egalitarian and typically Republican, and a lot of other things bother me about it. The notion that if you live in downtown Cleveland, by God, you ought to pay the penalty for living in downtown Cleveland or New Orleans. [Laughter.]

And it's only the folks who can afford to get out to the suburbs, where they aren't bothered by those problems, who ought to get the benefit.

We have gone through a system in this country where we encouraged people to get out of the Clevelands; we encouraged them to get out of the New Orleans. Go out and build yourself a nice home in the suburbs, and so forth. But we sort of sheltered that process; we saved the Clevelands by taxing their income when they went out there and bringing it back into the inner cities to help these mayors with some of these problems.

Now, this administration is saying, let's cut out that part of the process. Let's cut the programs. Let's go back to the core cities. And now let's not allow deductibility to act as some kind of equalizer for the folks who stayed in downtown Clevelands with their businesses and stayed downtown in the New Orleans with their homes, and paid the 37 percent higher taxes. Let's make everybody who can afford to, go to the suburbs. What's wrong with that?

Mr. PEARLMAN. Well, I think there are a couple of things wrong with that. I think that, No. 1, it's quite appropriate for the Congress to make a judgment that it wants to provide a certain level of support for State and local government. But it seems to me it should be a congressional determination; not one of city-by-city or State-by-State. And that's what the Federal deduction for State and local taxes does. No. 2, we have a Federal tax system, and we are defining a Federal tax base. And if there is going to be a fairness in a Federal tax system, some way we have to deal with the State and local tax deductions and the disparity around the country. And just finally one other item. This whole discussion, and the whole State and local discussion, assumes catastrophe for State and local programs, for State and localities' ability to finance. That is not what the data shows. Look at the ACIR study. Look at the National League of Cities study. And what you will find is the data does not indicate that State and local governments are not going to be able to maintain current levels of service even. Indeed, the only thing those two studies show is that the rate of growth in local spending may be affected and it's affected on a very de minimis basis, 1½ to 2 percent.

The CHAIRMAN. I want to make sure I heard you say something. I hope I didn't hear you say it. That indeed Congress ought to make the decision as to whether to aid downtown Cleveland or downtown Philadelphia. But the present tax code kind of willy-nilly discriminately aids some and not others or some greater and not others as great. Did you say roughly something like that?

Mr. PEARLMAN. Yes. What I——

The CHAIRMAN. And if we want to aid downtown Cleveland, we ought to get rid of this State and local tax deduction and appropriate some money for downtown Cleveland.

Mr. PEARLMAN. Well, no, I'm not saying that. [Laughter.]

I hope that I'm not forced into that response. But what I am saying, Senator, is I think we all have to recognize that the State and local tax deduction, fashioned as it is today, just says to every State and local government—I don't want to talk about Cleveland. I think it's unfair to single out a particular city. [Laughter]

Senator **DURENBERGER**. Talk about Minneapolis, Portland. [Laughter.]

The **CHAIRMAN**. Most other witnesses specify our towns when they testify.

Mr. **PEARLMAN**. Well, I'll use mine then. You determine what the level of the Federal expenditure is. And I don't think that's the role of the tax system. I think that's what tax reform is all about. And I think it's true with the State and local deduction as it is with other deductions.

The **CHAIRMAN**. Well, I'll tell you what bothers me, Ron. I've heard the argument that Treasury has made to those housing developers that use tax preferences to develop low-income rental housing. And I think the proposal of the President will effectively finish that. Gone. And I have heard from two different groups that have met with the Treasury, and the Treasury said, yes, it probably will, but that is something that should be handled through the Banking Committee and the Appropriations Committee if we want to subsidize low-income rental housing. That's just fundamentally foreign to my concept. If we are going to do something beyond the marketplace, we are better off to do it with the Tax Code than appropriations. And I hope that we are not hearing from you and the administration that, no, we are better off to do with appropriations because the Federal Government program with the grants and the strings and the centralization in Washington can better tell Minneapolis or Cleveland or Schenectady or Portland what they ought to do when those towns know what they ought to do.

Mr. **PEARLMAN**. Senator, I think when you are talking about a fundamental reform process which is not a revenue-raising process, as I think—at least most people think this one would not be; would be a revenue-neutral process—that we are not saying that. That State and local governments—again, I would like to emphasize that the data does not indicate that State and local governments are going to be turned on the ear in terms of maintaining programs and financing their important needs. But in addition to that, there's no net money coming out of that.

The **CHAIRMAN**. I understand that. What bothered me was the federalism philosophy I was hearing; not the tax part and not the tax reform philosophy that, indeed, we are better off to do it with appropriations.

Mr. **PEARLMAN**. No. I don't think you heard me say that. But I hope you just give me at least a couple of seconds to respond again.

My criticism of the federalism argument is not a criticism of the concept of the federalism. I think we all share the view that there is an important relationship between State and local governments and the Federal Government and it has to be maintained, and the role of the State and local government is critical obviously. I mean there is no dispute about that.

The thing that I was criticizing when I said "amorphous federalism arguments" is the mere emotional argument that by secondguessing the current tax system, by raising a question about the dedutibility of State and local taxes that we are throwing federalism to the wings. And I would submit to you that that we think that that is not true. And that the data would suggest that that is not true. And that federalism does not go down the tubes simply because we raise a question about the deductibility of State and local taxes.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Thank you very much, Mr. Chairman.

Mr. Pearlman, one of the questions here is what percent of the total tax paid, whether it be sales, income or property tax, is actually deducted. And I have some rough figures here that I would like you to corroborate if possible.

Of the total sales taxes paid, the amount itemized in 1982 was around 18 percent. Of the total income taxes collected at the State level, about 88 percent was itemized. Of the total property tax collected, around 35 to 38 percent of the total property tax was itemized.

If you don't have those figures at your fingertips, I would appreciate it if you could get them for me for the record. But I think if they are not exactly accurate they are ballpark. And what they tell us is that State local income taxes are itemized by a much higher proportion of the population than is due of the property tax.

My question is: Why? And my second question to you is if such a relatively small percent of the people who pay property taxes itemize them, why is that the case?

Mr. **Pearlman**. Senator, the numbers I have in front of me vary slightly from the ones you gave out. I'll be happy to submit those for the record.

PERCENT OF STATE AND LOCAL TAXES AFFECTED BY REPEAL OF ITEMIZED DEDUCTIONS—CALENDAR YEAR 1982

[Dollar amounts in billions]

State and local taxes	Itemized taxes paid deductions	Total State and local tax receipts[1]	Itemized taxes as percent of total taxes
Individual income taxes net of refunds	$38.96	[2]$52.92	74
Property taxes	28.68	83.75	34
Sales taxes	14.22	95.29	15
Other taxes	1.19	38.92	3
Total (net of refunds)	83.04	[2]270.88	31

[1] Fiscal years converted to calendar years with 75/25 percent conversion factor.

[2] Local income taxes includes some corporate taxes ($1.1 billion in 1983).

Source: 1982 statistics of income individual income tax returns and the "Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism," 1984 edition, tables 31 and 33.1.

Senator **Bradley**. Well, if you have them, we can take them now.

Mr. **Pearlman**. Well, the numbers I have indicate that the individual income tax—and that may be the difference. You might be including other taxes, I don't know. Seventy-four percent. I think you said 88 percent.

Senator **Bradley**. Right.

Mr. PEARLMAN. Property taxes, I show 34 percent. This is a total tax.

Senator BRADLEY. OK.

Mr. PEARLMAN. So they are fairly close.

Senator BRADLEY. Why do only 34 percent of the people who pay property taxes itemize? Why is that?

Mr. PEARLMAN. I can only speculate that there are lots of homeowners in this country—and we know. I mean the statistic I mentioned a moment ago that a substantial number of homeowners in this country who are at income levels where they don't have total itemized deductions that are in excess of the zero bracket amount and they simply don't itemize. That, obviously, suggests to me that property taxes must not be at levels in most jurisdictions that when combined with other deductions push them above the current zero bracket amount.

Senator BRADLEY. It also implies, if you carry this argument forward—and, again, I don't think we should eliminate the deduction, but just carrying this argument forward—that if only 34 percent of the property tax is itemized and the argument is that if we eliminate the deduction somehow or another there will be some kind of tax revolt, doesn't that also imply that the nonitemizers have no voice in the political process? Doesn't it necessarily mean that those who itemize control the political process even if they are a very small percent of the total population?

Mr. PEARLMAN. It does, Senator. And as we noted in our written statement, one of the things that was, frankly, surprising to us that in the two studies to which I referred a moment ago, one done on behalf of the ACIR and one, I think it is, the National League of Cities—I may be erroneously attributing it, but it's in the written statement—that in neither case did they take into consideration the effect of nonitemizers on the local process. And that is cler. There is no dispute that their analysis was done on that basis.

On that basis, they made a determination—those two studies made a determination that there would be between a 1½ and 2 percent, I think it is, effect on local spending. Obviously, nonitemizers have an effect on this decisionmaking process. And I think most people would agree with that.

Senator BRADLEY. So an argument that needs to be dealt with is the argument that itemizers will revolt and control the political process and force the property taxes to be cut with all the ramifications that follow. Those who make that argument have to demonstrate why nonitemizers have no voice in the political process. Is that not correct?

Mr. PEARLMAN. I think that's correct. Let me just offer one other thing. The other very important thing is that you really have to look very carefully at not just the property taxes, but the individual decisions that local taxpayers make with respect to property taxes. One of the big arguments that we hear is the elimination of the property tax is going to be the end of the educational system. And we present some data to suggest that that is not true. But one of the things that clearly is going to be the case is that people make different decisions about local services, and that itemizers as well as nonitemizers are going to be much more reluctant——

Senator BRADLEY. One last point.

Mr. **Pearlman**. Excuse me.

Senator **Bradley**. If you had a tax reform in which the zero bracket amount was increased even higher then the number of itemizers would be reduced even further. Is that not correct?

Mr. **Pearlman**. You mean even higher than we propose?

Senator **Bradley**. Yes.

Mr. **Pearlman**. Sure. Any increase in either the personal exemption or the zero bracket amount will reduce the number of itemizers. I think our estimate is that our proposal will reduce it by about 4 million taxpayers, but certainly it would go down further.

Senator **Bradley**. Thank you.

The **Chairman**. Further questions?

Senator **Durenberger**. One, briefly. Ron, on the issue of tax exemption bond, is the 1-percent test still open to be refined in some way?

Mr. **Pearlman**. Senator, from day one—and I measure day one on that issue from the date that the Treasury proposals originally came out last November—we have said to people in every forum we've had a chance to say it that if our definition of public purpose is not a workable one, if there is a better approach, we want to hear about it. The chairman asked a question to one of the Governors about the difficulty in making the public-private purpose distinction. We took the position that we wanted as mechanical a definition as possible so we didn't get into fights about what is or is not a public purpose.

Sure we recognize that people can quarrel both about the amount of the percentage, should it be 1 percent or should it be 2 percent; and they can quarrel about things that may be adversely affected that the Congress will determine is inappropriate. We have consistently said come in and talk with us, make your views known to the members of the tax-writing committees.

Senator **Durenberger**. Any great ideas on the table right now?

Mr. **Pearlman**. There are some. Very recently, for example, yesterday we received one and we are trying to analyze it now. They all, unfortunately, go back to much more subjective definitions of public and private purpose, which makes it not only difficult for the legislative process, but difficult for the tax compliance process. but, yes, there are other options on the table.

Senator, I am not an expert on federalism. I'll leave to you whether I'm an expert on tax laws.

The **Chairman**. One more question from Senator Bradley.

Senator **Bradley**. Ron, if you increased the zero bracket amount by another thousand dollars, how many people would become non-itemizers?

Mr. **Pearlman**. I couldn't even guess. I'll be happy to provide that. I think it would be an easy number for us to provide.

Senator **Bradley**. I would like for you to provide it for 1,000 and 2,000.

Mr. **Pearlman**. Certainly. I'll be happy to do that.

[The information from Mr. Pearlman follows:]

An increase in the zero bracket amount (ZBA) of $1,000 in 1983 would have reduced the number of tax returns with itemized deductions by approximately 5 million or 14 percent. In these cases, the tax returns had excess itemized deductions of

$1,000 or less. An increase in the ZBA of $2,000 in 1983 would have reduced the number of itemizing tax returns by approximately 10 million or 30 percent.

The CHAIRMAN. Thank you very much.

Mr. PEARLMAN. Thank you.

Mr. Chairman, do you want me to stay?

The CHAIRMAN. I would like you to stay, yes, and listen to this next panel because you may want to respond to some of the things they say.

This is a panel of the Honorable Ernest Morial, the mayor of New Orleans; the Honorable George Vionovich, mayor of Cleveland; the Honorable John J. Marchi, chairman, Senate Finance Committee, New York State Senate; the Honorable Ann Klinger, Board of Supervisors, Merced County, CA; and Jonathan T. Howe, second vice president, National School Boards Association, Rockford, IL.

Again, unless you have objections, we will follow the order that appeared on the witness list. And we will start with Mayor Morial first.

Mr. Mayor?

STATEMENT OF HON. ERNEST MORIAL, MAYOR OF NEW ORLEANS, LA, AND PRESIDENT, U.S. CONFERENCE OF MAYORS

Mayor MORIAL. Thank you, Mr. Chairman.

Mr. Chairman, and members of the committee, it is certainly a privilege to appear before you today on behalf of the U.S. Conference of Mayors. And we certainly thank you for the opportunity to do so.

I have a brief statement on the very important subject of tax reform. With your permission, we would like to file a more detailed testimony for the record.

The CHAIRMAN. All of your statements will appear in the record in full.

Mayor MORIAL. The mayors of this country are concerned about the Federal deficit, and we think we have demonstrated our willingness to do our share in efforts to reduce it. We have accepted sharp reductions in direct Federal assistance in the past 5 years. For example, between 1979 and 1984, direct Federal aid for housing and community development was cut almost in half from $40.3 billion to $22.5 billion. Overall, direct Federal expenditures for major city programs were reduced from almost $70 billion to less than $39 billion. These are major losses. They have forced cities to local initiatives and local resources to meet major housing development and infrastructure needs. The administration's proposed changes in the Tax Code, specifically those which would terminate the deductibility of State and local taxes and the tax exemption of many municipal bonds and eliminate the rehabilitation and historical preservation tax credits, strips cities of the ability to fend for themselves, at the same time that loss in Federal aid programs require that they do so.

The principal reason for the tax reform is fairness but the proposed changes violate the principle of fairness.

Deductibility of State and local taxes is an extremely important fairness issue. In testimony before this committee exactly 1 month ago, Senator Domenici pointed out that eliminating deductibility will increase resistance to State and local taxes and make it more difficult for these governmental entities to maintain or increase needed revenue.

For local governments, finding sources of revenue in the face of more than $30 billion in Federal cuts with more being proposed in the current budget negotiations has become a problem more critical than it has ever been before. In the best of circumstances, it is difficult for local governments to raise revenues even for services citizens deem to be sanctioned. The tax proposed by the Federal Government is never submitted to the voters for approval. In cities and in many States, the citizens often have to vote to tax themselves. Education would be a major casualty of the loss of deductibility. Almost 36 percent of all State and local expenditures is earmarked for education. Taxpayers almost always voted on the revenue for such expenditures directly.

I would like to comment briefly on bonds and the additional restrictions on tax-exempt issues proposed by the administration. The Conference of Mayors has joined other State and local organizations in their statement opposing these restrictions, and with your permission, I am submitting the text with my testimony for the record.

Senator DURENBERGER. It will be made part of the record.

Mayor MORIAL. We believe that Congress has placed enough restrictions on the municipal bond market in recent years. Just last year, this committee and Congress imposed State volume caps and other restrictions. In each of the last three tax bills, restrictions have been adopted. The administration's proposals would make it virtually impossible to finance multifamily or low-income housing, airports, solid waste and waste water treatment facilities, nonprofit hospitals and health facilities, and other important, indeed, essential infrastructure project. Many economic development activities now carried on in cities would cease. The Treasury Department refers always and only to the revenue gain if tax exemption of most State and local bonds is eliminated. It never takes into account the increased economic activity generated through tax-exempt interest rates, the jobs created and the profits made and the increased taxes paid to all levels of government as a result.

The Treasury assumptions that there is no economic return in increased Federal revenues and that all bondholders would reinvest in taxable instruments are patently incorrect and result in quite erroneous estimates of Federal revenue gains if tax-exempt bonds were to be eliminated.

Finally, the Conference of Mayors has deep misgivings about the proposed termination of rehabilitation and historic preservation tax credits. These credits have been used in almost every central city across the country to revitalize older buildings in downtowns and neighborhoods. It is extremely important that these efforts be continued. The historic tax credit alone has generated $5 billion in private investment in 6,800 histroic buildings and added $4 billion to local wages. The fact that such credits are not only tax expenditures, but generate Federal revenue, should not be ignored, as the Treasury Department does.

In my prepared statement I have attached the Conference of Mayors' position on tax reform and the deductibility of State and local taxes adopted by a near-unanimous vote at our annual meeting last month. I respectfully ask that that also be included in the record.

Senator DURENBERGER. Without objection, it will be.

Mayor MORIAL. Mr. Chairman, and members of the committee, again, I thank you on behalf of the Conference of Mayors for this opportunity to appear before you. You have a very difficult task in trying to fashion a tax plan and no one amongst us, I am sure, envies that position. As you strive to achieve something fair and equitable, we pledge to you the full cooperation of the U.S. Conference of Mayors. But I urge you to reconsider those proposals in the administration's tax plan that are adverse to Americans that live in cities, the vast majority of us. State and local tax expenditures comprise only 9 percent of all tax expenditures in the Tax Code, yet they total 67 percent of the modifications proposed in the President's tax plan. The goal of tax reform is fairness and we endorse that. We do not believe it is fair that we and the people who live in the cities should bear the major burden of tax reform.

Thank you.

Senator DURENBERGER. Thank you. Thank you for your lack of envy.

[The prepared written statement and additional information from Mayor Morial follow:]

UNITED STATES CONFERENCE OF MAYORS
1620 EYE STREET, NORTHWEST
WASHINGTON, D.C. 20006
TELEPHONE: (202) 293-7330

TESTIMONY OF

THE HONORABLE ERNEST MORIAL

MAYOR OF NEW ORLEANS

PRESIDENT

U. S. CONFERENCE OF MAYORS

before the

FINANCE COMMITTEE
U.S. SENATE

July 25, 1985

Mr. Chairman and members of the Finance Committee, thank you for this opportunity for the U.S. Conference of Mayors to testify on the very important subject of tax reform. The Conference of Mayors has a few major concerns about the President's tax reform proposals, particularly the Administration's recommendations to terminate the deductibility of state and local taxes, to end the tax exemption of many municipal bonds and to eliminate the rehabilitation and historic preservation tax credits.

Every American is concerned about the federal deficit and improving the fairness of the federal tax code. Cities are prepared to do their share. But changes in urban programs which have been made in the last five years make these tax proposals doubly unfair to Americans who live in cities. No group of Americans should be so adversely treated as we pursue solutions to national problems.

Deductibility of state and local taxes is an extremely important fairness issue for taxpayers who itemize deductions. Despite what the Treasury Department says about the deduction benefiting primarily upper income individuals, the truth is that over one half of the households who benefit from deductibility have incomes below $30,000 and 87 percent have incomes below $50,000. Moreover, over 33 million households benefit from the deduction; -- more than any other deduction in the tax code; in contrast the house mortgage interest deduction is taken by 25 million households.

Principles of fairness are violated in several ways. First, state and local taxes paid do not represent disposable income to a taxpayer for the purpose of federal taxation. The elimination of deductibility will result in a tax on a tax, and that simply does not seem fair to most taxpayers.

Another inequity relates to education. A person making charitable contributions to a church so as to keep a child in a parochial school would be able to itemize the deduction in most cases. In contrast, a taxpayer paying local property taxes to support the public school system would not be able to deduct those taxes. While I believe that charitable contributions should continue to be deducted, state and local governments and public school systems deserve the same treatment as the private sector.

Third, while taxes paid to state and local governments would no longer be deductible, taxes paid to foreign countries would enjoy a continued tax credit. Certainly, the cities of the U.S. should be treated as well as Saudi Arabia or Japan.

Last, while homeowners, many of them elderly or middle income families, would not be able to itemize and deduct state and local taxes paid, those who hold rental or income producing property would continue to be allowed to take the deduction. This represents substantial discrimination against homeowners.

Education would be extremely hard hit by the President's proposal to eliminate the deductibility of state and local taxes. Almost 36 percent of all state and local expenditures are earmarked for education. Moreover, education is usually one of the few local expenditures which taxpayers almost always vote on directly. Thus the effect on education expenditures may be more direct and immediate and substantially greater than currently realized.

The federal income tax since the Civil War has preserved deductibility of state and local taxes as a major federalism principle. Terminating this deduction would undermine nearly everyone's concept of "New Federalism". Moreover, the losses which state and local governments would suffer under the tax plan occur on top of other losses we have sustained in recent years, through cuts in direct spending programs and other adverse tax proposals.

Elimination of deductibility threatens reduced property values and reduced property tax collections for cities. There have been some estimates that the value of homes nationwide would decline by three to four percent. That represents a substantial loss in appraisals and revenues for city governments, not to mention a substantial loss for homeowners.

The Congressional Research Service estimates that state and local governments will be forced to cut their services by 47 cents for every dollar the Treasury gains for eliminating deductibility. By 1990, this would mean a $19 billion cut in basic services, affecting every locality and state government in the country.

Elimination of deductibility may also result in increased migrations of middle and upper income families out of relatively high tax cities, further reducing the tax base of cities.

Finally, too, the repeal of deductibility is expected to put downward pressure on bond credit ratings, since cities will look like less attractive credit risks. This will make important infrastructure investments all the more costly or beyond the reach of many cities.

The repeal of deductibility has been mislabeled as a loss for a few high tax states. The truth is that all states and local governments will lose. Moreover, cities tend to be relatively high tax jurisdictions relative to surrounding suburbs and rural areas consequently they may lose the most, regardless of whether they are located in a high tax or low tax state. It simply costs more to provide the same level of police and fire protection and to maintain streets and parks in central cities. Moreover, few chronically mentally ill live in the suburbs, few long term unemployed live in the suburbs. The cities are the homes of most of the disadvantaged, the poor, and those in need of services.

It is no wonder that recent polls taken by George Gallup, Newsweek, and USA Today all show taxpayers disapproving the President's plan to eliminate deductibility of state and local taxes.

I would like to comment briefly on bonds. The Conference of Mayors has signed a statement, along with other state and local organizations, opposing the Administration proposals to eliminate the tax exemption of many state and local bonds. Specifically we oppose the one percent test, the arbitrage and advance refunding proposals, the elimination of bank deductions for the costs incurred in buying or carrying municipal bonds and other proposals. A copy of that joint statement is attached to my testimony.

The Conference of Mayors believes the Congress has placed enough restrictions in recent years on the municipal bond market. It was just last year that this committee and the Congress imposed state volume caps and other restrictions on bonds. In each of the last three tax bills, restrictions have been adopted.

Removing the tax exemption of bonds would be a disaster for cities. The Administration proposals would make it virtually impossible to finance multi-family or low income housing, airports, solid waste and wastewater treatment facilities, docks and wharves, non profit hospital and health facilities, sports stadiums, convention centers and economic development projects, as well as many utilities, water and sewer facilities and other important infrastructure projects.

The Treasury Department is fond of citing statistics that show the revenue gain to the Treasury if the tax exemption of most state and local bonds is eliminated. However, their estimates do not take into account any increased economic activity generated as a result of tax exempt interest rates -- the increased jobs and profits and thereby increased tax revenues paid by individuals and corporations to federal, state and local governments. The Treasury assumption of no economic reflows to the federal government and their assumption that all bondholders will reinvest their funds in taxable instruments can lead to very erroneous guesses of the revenue gains associated with their proposals.

Removing the tax exemption of bonds represents a major cost shift from the federal government to states and localities. The increased cost to state and local governments is estimated to be 30 percent higher without tax exemption or $39 billion over the 1986-1990 period, under current estimates of bond activity.

The Conference of Mayors also has deep misgivings about the proposed termination of existing rehabilitation and historic preservation tax credits. These credits have been used in almost every central city across the country to revitalize older buildings and downtowns and neighborhoods. It is extremely important to the long-term economic health and viability of cities that these credits be maintained. The historic tax credit alone has generated $5 billion of private investment in 6,800 historic buildings and added $4 billion to local wages.

I have attached to my statement the Conference of Mayors policy positions on tax reform and the deductibility of state and local taxes. These were adopted at the annual meeting of the Conference of Mayors last month. I might add that the votes on these resolutions were nearly unanimous.

Mr. Chairman, I do not envy the job of this Committee in fashioning a tax plan. Most mayors endorse the goals and importance of tax simplification and reform and recognize how difficult the task is to design a sensible and politically popular plan. However, we do not believe it is fair that we should bear the major burden of tax reform. State and local tax expenditures comprise only nine percent of all tax expenditures in the tax code and yet total 67 percent of the proposed modifications in the President's tax plan.

We urge this Committee to reconsider the proposals adverse to Americans who live in cities, including the bond proposals, the proposed termination of deductibility of state and local taxes and the repeal of historic and rehabilitation tax credits.

Thank you for the opportunity to testify this morning. We pledge our continued cooperation with you as you strive to fashion a sound and equitable tax reform plan.

Resolution No. 57

Deductibility of State and Local Taxes

Mayor Joseph Sensenbrenner
Madison

Mayor Winfield Moses
Fort Wayne

1) WHEREAS, the elimination of the deductibility of state and local taxes has been included in several tax "reform" packages, including the Administration's; and

2) WHEREAS, this change would be the most fundamental and far-reaching change in our federal system of government since the Civil War; and

3) WHEREAS, taxing taxes is an abdication of basic principles of fairness to American taxpayers and violates the fundamental tenets of our federal system of government; and

4) WHEREAS, the repeal of deductibility will raise taxes for the majority of middle income citizen's, those 40 percent of all taxpayers who itemize, who pay 70 percent of the nation's taxes, and thereby increase their resistance to paying for any state and local services; and

5) WHEREAS, recent cuts in federal urban programs make it all the more important that cities retain the flexibility to raise local revenue to meet pressing needs; and

6) WHEREAS, the repeal of deductibility would make it more difficult for cities to provide basic services and would lead to declining property values and property tax collections and have other adverse effects on cities; and

7) WHEREAS, many cities, because of the greater needs of urban residents and higher costs of providing services, are relatively high tax jurisdictions relative to surrounding areas; and

8) WHEREAS, because approximately one half of local taxes are devoted to education, the repeal of deductibility would have the most adverse effect on our public school system at a time when excellence in education is our nation's most important human development priority,

9) NOW, THEREFORE, BE IT RESOLVED that the U.S. Conference of Mayors calls upon the Congress to oppose a tax on taxes

and to preserve the current deductibility of state and local taxes, as an important feature of fiscal federalism and as a way of preserving the overall fairness of our tax system for middle income taxpayers.

Resolution No. 3

Tax Policy

Mayor Joseph Sensenbrenner
Madison

Mayor Winfield Moses
Fort Wayne

1) WHEREAS, the U.S. Conference of Mayors strongly supports tax reform which embodies the concepts of equity, simplicity, economic opportunity, progressivity and preserving the historic relationship of state and local governments to the federal government; and

2) WHEREAS, the Administration has proposed a tax reform plan which proposes the elimination of deductibility of state and local taxes, the elimination of the tax exemption for nearly all state and local bonds, the elimination of rehabilitation and historic tax credits, the elimination of banks' deductions of costs incurred in buying and carrying municipal bonds and limitations on charitable contributions; and

3) WHEREAS, there is increasing support for tax reform in the U.S. Congress and pressure to adopt lower tax rates, impose minimum taxes on high income individuals and corporations, and take the working poor off the tax rolls; and

4) WHEREAS, the elimination of the tax exemption for many municipal bonds (those where more than one percent of the proceeds flow to any entity other than a state or local government) would jeopardize many public services, including water and sewer projects, resource recovery, low income housing, docks and wharves, airports, hospitals, utilities, bonds for economic development, mortgage revenue bonds, the control of acid rain and environmental problems, student loan bonds and other important programs; and

5) WHEREAS, significant reforms have already been enacted by the Congress which restrict the use of industrial development bonds and mortgage revenue bonds; and

6) WHEREAS, the elimination or rehabilitation and historic preservation tax credits, along with the elimination of the investment tax credit, jeopardizes the rehabilitation of older commercial buildings, central city downtowns and old, declining neighborhoods; and

7) WHEREAS, the elimination of banks' deductions of the costs involved in buying and carrying municipal bonds would virtually eliminate the banks as purchasers of municipal securities and raise interest costs for state and local governments; and

8) WHEREAS, restricting current charitable deductions may reduce substantially the important services provided by the churches, United Way organizations and others in providing food, shelter and other services to the poor, the disadvantaged, the elderly and other city residents; and

9) WHEREAS, many large corporations and wealthy taxpayers pay no federal taxes whatsoever,

10) NOW, THEREFORE BE IT RESOLVED that the U.S. Conference of Mayors calls upon the Congress to continue to allow the use of tax exempt bonds for important public purposes, including, but not limited to, low and moderate income housing, resource recovery, docks and wharves, airports, water and sewer projects, hospitals and health facilities, utilities, transit, environmental protection, prisons and the like; and that small issue industrial development bonds be available in a targeted fashion to those areas that need them most; and

11) BE IT FURTHER RESOLVED that the U.S. Conference of Mayors calls upon the Congress to protect the municipal bond market by continuing to allow bank deductions of carrying costs on municipal bonds; and

12) BE IT FURTHER RESOLVED that the U.S. Conference of Mayors calls for the retention of rehabilitation and historic tax incentives as important tools for revitalizing cities; and

13) BE IT FURTHER RESOLVED that the U.S. Conference of Mayors calls upon the Congress to reject proposed restrictions on charitable contribution deductions as likely to undermine important services for our low income citizens; and

14) BE IT FURTHER RESOLVED that the U.S. Conference of Mayors calls upon the Congress to impose higher minimum taxes on high income corporations and individuals, to retain certain tax credits for child care needs, and to raise personal exemptions and deductions to eliminate low income workers from the tax rolls so as to enhance the progressivity of the income tax system.

Projected Cost: No additional revenue loss.

Comments on the U.S. Treasury Tax Reform Proposal

The U.S. Treasury Department proposes to change the federal income tax by instituting a modified flat tax that reduces the present number of tax brackets to three while broadening the tax base by eliminating many exclusions, deductions, exemptions, and credits. Many of the provisions contained in the Treasury plan are likely to have a profound impact on the municipal bond market. The Public Securities Association estimates that between 62 and 80 percent of all municipal bonds will lose their tax-exempt status under the plan. These comments summarize the specific concerns that state and local government public interest groups have with the provisions affecting tax-exempt bonds and the reasons they withhold support for the plan.

1. We oppose the Treasury distinction between "governmental" and "nongovernmental" purposes.

   The proposal to deny tax exemption if (1) more than one-percent of the municipal bond proceeds are used directly or indirectly for nongovernmental purposes and (2) if the facilities are not available on the same basis for all members of the general public presents substantial difficulties. Many general obligation bond programs may be affected because of the one-percent rule. Tax-exempt revenue bond financing for many other state and local government functions -- such as airports, water systems, sewers, mass transit, and port facilities -- will be precluded or made more difficult.

2. We oppose the restrictions on "on-behalf-of" issuers.

   Tax-exempt bonds are issued by states and political subdivisions or by others on-behalf-of states and political subdivisions. Considerable difficulty has been and will be encountered in defining an on-behalf-of issuer. Detailed and complex requirements for eligibility to continue financing on a tax-exempt basis must recognize highly diversified governmental structures in 50 states. For example, school, water and sewer districts may be precluded from issuing tax-exempt bonds.

3. We oppose any modification in the corporate minimum tax that further reduces the deduction taken by banks and other financial institutions for the costs incurred in buying and carrying tax-exempt obligations.

   In recent years, the market for municipal bonds has been supported by individual investors whose marginal tax rates rose with increases in income because of high inflation. At the same time, the demand for municipal bonds by banks and other financial institutions decreased dramatically because of the reduced profitability of these institutions, the expansion of competing ways to reduce taxable income, and previous tax law changes affecting the deduction taken by these institutions in connection with municipal obligations. Historically, these institutions were major purchasers of our obligations.

4. We oppose the imposition of further restrictions on arbitrage unless there are clearly identified problems and targeted solutions.

   The investment of bond proceeds at market rates for a reasonable period of time pending their application for the purposes of the bond issue is good cash management. Arbitrage, which is the term used to describe the interest earned on invested bond proceeds in excess of the interest being paid on the bonds, reduces the cost of public projects by reducing the total amount of bonds issued for a project. State and local governments should not be penalized for practicing good financial management by being required to "rebate" such investment earnings to the U.S. Treasury or by the imposition of other unnecessary restrictions.

5. We oppose the extension of certain requirements in current law to all municipal bonds.

   The Treasury proposal will extend requirements that were enacted to restrict borrowing for "private purposes," such as the IDB reporting requirements, to all tax-exempt bonds. These requirements will impose greatly increased administrative burdens on states and local governments and increase their costs.

6. We oppose the prohibition of all advance refundings unless there are clearly identified problems and targeted solutions.

   The prohibition of all advance refundings fails to distinguish legitimate and justified advance refundings from those that are abusive. Where interest cost savings of a significant magnitude can be realized and where the elimination of burdensome restrictions, relief of financial distress or rearrangement of debt service is warranted, the ability to advance refund bonds is desirable.

7. We oppose restrictions on public/private partnerships.

   The Treasury proposal, if adopted, will seriously restrict the ability of states and local governments to continue to finance facilities on a public/private partnership basis. For example, it would impair the present financing and construction arrangements for such facilities as solid waste disposal.

Council of State Governments
Government Finance Officers Association
International City Management Association
National Association of Counties
National Association of State Budget Officers
National Conference of State Legislatures
National Governors' Association
National League of Cities
United States Conference of Mayors

STATEMENT OF HON. GEORGE VOINOVICH, MAYOR OF CLEVELAND, OH, AND PRESIDENT, NATIONAL LEAGUE OF CITIES

Senator DURENBERGER. George Voinovich, the mayor of Cleveland.

Mayor VOINOVICH. Thank you. I'm pleased to be here today to testify on behalf of the National League of Cities. We represent some 15,000 cities.

First of all, Senators, we would like to point out that Federal tax policy is the most important determinant of national municipal policy. Our chart here shows the Social Security going up, programs for cities going down, the deficit going up, and tax expenditures going up. So tax expenditures are having a dramatic impact on lives of cities throughout this country.

Second of all, we in this panel aren't down here representing some special interest group. We are here representing the same people that you represent in your respective States. And many of us resent that on occasion we have been treated as some kind of a special interest group down here grinding our own particular ax.

We are here not to talk about just deductibility—that's just one thing. For example, deductibility in Cleveland means that my people will pay less taxes. We only have 21 percent of our people that itemize their deductions. But I have got to look beyond that. I've got to look at, for example, in 1984 we passed a school levy. In Ohio, you have to vote for a school levy in order to get money from the property tax. It passed by 1,000 votes. If deductibility had been eliminated, it wouldn't have passed. I've got to look out to the Greater Cleveland area, the last bastion of quality education in our suburbs where people reach into their pockets and pay heavy property taxes to provide a decent education for their children, and evaluate what impact the elimination of deductibility is going to have on public education in Greater Cleveland, the State of Ohio, and the United States of America. I've got to look at the investment tax credit as part of this package, and realize that we have smokestack industries in our area heavy in manufacturing and say to myself my people may be paying less taxes, but they may not be working. Or I have to look at the elimination of deductibility of charitable contributions.

We lead the United States of American in per capita giving to the United Way. We are going to raise $55 million this year. And my United Way people tell me if tax reform two goes into being that we are going to lose a lot of that money because they are going to lose that deductibility. And they can prove to you that when you allow 25 percent to be deducted, they had an increase in people that participated in providing charitable contributions.

Or I have to look at my downtown and realize the rehabilitation credit for historic buildings has contributed to the renaissance of downtown Cleveland. Or you have to realize that accelerated depreciation has been critical to the supply of family units that we have had out in our neighborhoods.

So we really have to look at the big picture in terms of whether or not this is good. I think most of us have concluded that the devil you know is better than the devil you don't know. And we are better off with what we have.

Second of all, we think it ludicrous, and we enunciated this again at a meeting in Cleveland of our board, that you are talking about tax reform when we have this monumental deficit in our country. We think you ought to forget about tax reform and concentrate on the deficit. We think the tax reform should never be considered unless it's considered in conjunction with a deficit that needs to be solved.

We think Senator Chafee, for example, makes a lot of sense. He says let's take tax expenditures for the next 5 years and cut them 10 percent each year and raise $160 billion and apply them right against the deficit, right across the line; we should do something with that.

So what we are basically saying is that we think this tax reform ought to be looked at in terms of the national goals of this Nation; taking care of the deficit. Are we goinmg to be a manufacturing country? What impact is it going to have on the well-being of cities that have not participated in the economic recovery?

Moreover, we think that what you ought to do is get every component of every issue on the table. If you are talking about housing, let's look at what we are doing with direct assistance. Then let's look at what tax reform two does in eliminating some of the incentives for multifamily or low income. And then let's look at the special incentive that you are giving homeowners in the United States by deducting interest from their mortgage payment. And what you ought to do is decide does the Federal Government have a role in housing in the United States of America. If the conclusion is no, then get rid of all programs—direct assistance and indirect assistance—in the area of housing. Treat everybody alike and then apply that money to reducing the deficit.

Or if you decide yes we have a role, we have a role in providing multifamily housing for people in the United States of America, then how do we best do that? Through direct assistance or through indirect assistance through tax expenditures?

I think it's time and the National League of Cities thinks it times that we put all of it on the table and looked at these issues from a national policy point of view with the heaviest emphasis on doing something about our deficit.

Senator **DURENBERGER**. George, thank you very much.

[The prepared written statement of Mayor Voinovich follows:]

National
League
of
Cities

1301 Pennsylvania Avenue NW
Washington, D.C.
20004
(202) 626-3000
Cable: NLCITIES

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STATEMENT OF

THE HONORABLE GEORGE V. VOINOVICH

MAYOR, CLEVELAND, OHIO

AND PRESIDENT OF

THE NATIONAL LEAGUE OF CITIES

on

FEDERAL TAX REFORM

before the

COMMITTEE ON FINANCE

UNITED STATES SENATE

July 25, 1985

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STATEMENT

OF

GEORGE V. VOINOVICH, MAYOR OF CLEVELAND, OHIO

AND PRESIDENT OF

THE NATIONAL LEAGUE OF CITIES

July 25, 1985

Mr. Chairman and distinguished members of the committee, I am George Voinovich, Mayor of Cleveland, Ohio and President of the National League of Cities--the largest and oldest organization representing the nation's cities.

I appreciate and welcome the opportunity to testify today, and I hope my testimony will be of some assistance to you as you attempt to reform the Internal Revenue Code.

We, as city leaders, have an especially complex and critical stake in how this committee acts on this issue. Federal tax policy is the single most important determinant of national urban policy today; consequently, any changes will have profound impacts on our ability and authority to raise revenues to meet our own responsibilities.

Like you, every member of our organization is a public elected official. Together, our membership represents about 60 percent of our country's citizens. Thus, individually and collectively, our national municipal policy is shaped by the same demands and pressures which confront you.

For, it is fair to say that substantive tax reform--no matter what it includes or excludes--will affect every municipality; and yet no two will be affected in exactly the same manner. Many cities will benefit; many will be hurt; and many will come out about even.

Although some in the public sector have asserted that the only items affecting cities in tax reform are deductibility and municipal bonds, that is not the case. As taxpayers, corporate and individual, alter their behavior to comply with new tax laws, every city is affected. Therefore, our interests and perspective are remarkably similar to this committee's.

Thus, for us, we believe federal tax reform must be evaluated not as a rate cutting exercise with an effort to squeeze and grab revenue from wherever it can be plucked, but rather from the perspective of how we as a society--the wealthiest on earth--are going to distribute our shared wealth and resources to improve our welfare as a people.

The National League of Cities views this time as an opportunity to restore order and sense to our federal system. We believe you have an opportunity to help set the nation aright again, and to provide for a more thought out national municipal policy.

A Taxing Year for Cities

While many have come to recognize that our current tax system unconsciously determines a national industrial policy, we recognize that it, and you, currently determine national urban policy.

Since 1979, we have witnessed more than a 50 percent reduction in federal direct assistance to cities. This year, the administration proposed to eliminate or phase out all remaining assistance. Yet, in this same period of time, federal tax expenditures in the areas most important to cities--housing, economic development, employment, infrastructure, and fiscal balance--have increased dramatically. The federal tax code has, inadvertantly, become the single most important vehicle through which the federal government channels capital to our nation's cities.

Given the enormous influence of tax policy on municipal issues, you can understand why major changes could have such a significant impact on the shape of our municipal future.

The Deficit and Cities

In 1981, we were told that a major cut in federal assistance to cities, coupled with a major tax cut would produce a balanced budget by 1983. In January of this year, with federal deficits and trade deficits reaching extraordinary levels, we were told that the elimination of city programs would lead to a balanced budget.

Now we know that premise is similarly false.

We believe, and our Board of Directors voted overwhelmingly less than two weeks ago, that this committee should "defer any further consideration of tax reform until a more effective plan to close the gap between federal expenditures and income has been implemented." We recognize that any such plan will require an increase in federal revenues, and we urge that this reality be confronted immediately and directly. Indeed, we offer our support and respect for Sen. Armstrong and the other Senate conferees who recognize that any realistic effort to achieve meaningful deficit reductions will require applying the same scrutiny to tax expenditures as direct expenditures.

We believe that the "Berlin Wall" constructed to separate tax and spending policy is damaging to national policy and has led to high deficits. We know of no family, no busines, no city, no county, and no state which makes its spending decisions independent of its revenue or income decisions. Indeed, we note that tax spending, projected at a level of $400 billion next year, is twice the current projected deficit.

Despite discussions of revenue neutrality, we believe that dealing with the deficit, the international trade deficit, and our foreign debt status is our country's single greatest priority--not a co-priority with tax reform. We believe it would be inappropriate for the Congress to give serious consideration to any tax reform measure that does not provide steps for reducing the federal deficit.

Lacking leadership from elsewhere, we believe consideration of tax reform provides a unique, historic, and critical opportunity for this committee to restore the national to an even keel.

Municipal Policy Issues

There have been a plethora of goals and objectives announced for federal tax reform. Some desire a disguised further reduction in rates. Others call for neutrality--much as in Treasury I. Unfortunately, nearly all appear to maintain the artificial distinction between tax and fiscal policy. Many of these proposals simply remove some of the tax ornaments from the IRS Christmas Tree only to replace them with others.

I am, for instance, frankly confused about discussions of 'fairness' when considering legislation which would reduce taxes on our wealthiest citizens--those who have not been asked to make any contribution to help reduce the deficit--from 1979 by more than half, while our country's very poorest families, the ones who have suffered the deepest cuts to reduce the deficit--would apparently owe more in federal taxes under any of the pending proposals than they would have in 1979.

Similarly, I confess that I find it difficult to understand how fairness applies to any proposal which would eliminate incentives for the construction or rehabilitation of low income housing, but only modify tax subsidies for those who wish to purchase vacation homes and condominiums, and continue unlimited growth in tax benefits for those who can afford to own their own homes. In 1979, the federal government provided $30.3 billion in direct assistance for low and moderate income housing, and $28.3 billion in housing related tax expenditures. By 1986, the adminsitration budget proposal called for a cut in direct assistance to $6 billion, but housing tax expenditures of $67 billion. I am mystified, as I came this morning from a city of thousands upon thousands of homeless families and childrens, just what our federal housing policy is. How is it that out federal government can afford so very little for those in need of safe and sanitary shelter, but can afford ever growing subsidies for those who can?

Tax Expenditures and Cities

I would, Mr. Chairman, like to include for the record an issue brief on Taxing Questions for Cities and bar charts showing the extraordinary increases in federal tax expenditures over the past six years at a time when so many direct expenditure programs have been cut severely. These charts display the extraordinary growth in federal spending through the tax code at a time when direct domestic spending has been subject to severe cuts.

To us, there has been a growing dichotomy in federal policy making--and a growing gulf in understanding. As the federal tax code has become nearly impossible for ordinary mortals, much less elected officials, to understand, it has added confusion. Other authorization committees in the House and Senate continue to report bills on issues under their jurisdiction, but often unaware of the impact of changes in proposals pending before this committee--changes which might far outweigh their own.

At one time, this committee was responsible for raising taxes, while others were responsible--through the budget, authorization, and appropriations process--for spending. That is no longer the case. Tax expenditures now dwarf the combined direct expenditures for all state and local governments.

For cities, it is important that if this process is to continue, there be a means to achieve better coordination.

Tax Reform Opportunities

We believe the tax reform process provides an opportunity to phase out tax expenditures. In our view, this would mean Congress could use tax reform to reduce the federal deficit. It could use the revenue increase to deal with the most critical issues facing the nation. It could use the tax reform process to restore greater integrity to the policy process. I believe that the legislation proposed by Sen. Chafee is an important and welcome step in the direction of tax reform and deficit reduction.

For example, I can't say that all tax expenditures are more inappropriate than direct assistance. Indeed, our preliminary information indicates that the targeted jobs tax credit is more effective than many direct employment assistance programs. What I am sure is that we need a better system to determine how, at a time of limited resources, we can make the best use of them.

We believe that all federal resources devoted to any policy area ought to be considered together and ought to be subject to the same budget scrutiny in order to determine how best to meet the nation's needs.

Moreover, we believe that if the Congress wishes to increase spending in any area, it ought to raise the taxes to pay for any such new spending. We ought to pay as we go.

NLC Policy

Mr. Chairman, NLC devoted nearly two years to the development of policy on federal tax reform. At our annual Congress of Cities in Indianapolis last November, our full membership adopted tax reform policy--the day before former Secretary Regan submited his proposal to the president.

Two weeks ago in Cleveland, our Board of Directors reviewed that policy in the context of all that has happened since. I am pleased to report to you that we reaffirmed that policy, and I would like, with your permission, to include it with my testimony for your information.

We believe that federal tax reform should:

o reduce the large number of existing tax exemptions, deductions, and credits which narrow the current tax base;

o be phased in over a number of years;

o provide for adequate current revenues to finance the federal government;

o not reduce progressivity;

o not reduce the ability of cities to raise revenues and capital;

o remove current tax provisions which favor consumption over savings;

o make all tax preferences uniform in value to individual taxpayers and limit the total of all preferences to any one individual;

o neutralize the effects of inflation tax liabilities; and

o equalize the effective tax rates among industries.

Since 1982, the administration's thrust has been to turn over to states and cities and counties responsibility and accountability for a growing array of services. As initially proposed, the president's "new federalism," recognizing the cost of these turnbacks and mandates to us, promised to turn back revenue sources.

The administration tax bill, however, does exactly the opposite. By proposing to eliminate the deductibility of state and local taxes, and by eliminating the tax exemption on all but a very narrow range of municipal bonds, but restricting even those, the administration proposal would obstruct state and local government access to revenues necessary to support those very same services.

Deputy Assistant Secretary McClure has stated that state and local spending is too high. Assistant Secretary Pearlman said the administration tax proposal would force states and local governments to cut expenditures between 1.5 and 3 percent.

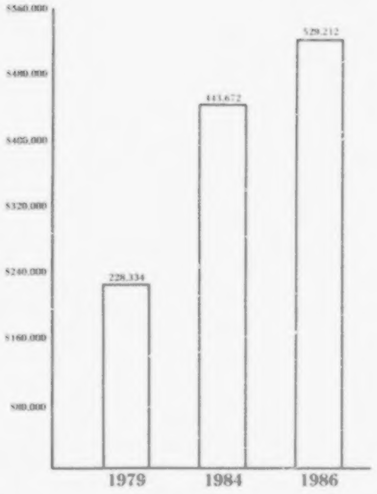
I must be honest with you. The concept that a federal bureaucrat--not elected by anyone--should arrogate to himself or herself the right to tell elected public officials how much they should or should not spend is preposterous. It does not belong in this country--in our political system.

It is to the people who elect you and me that we are and should be responsible.

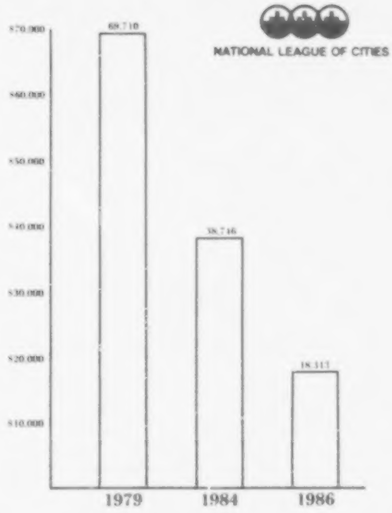
In closing, I want to thank the committee for inviting me. I find your task to be awesome, so I hope you will not be railroaded into acting prematurely. Certainly, given the magnitude of changes proposed, and the enormity of the impact on the nation, your job demands proceeding only after the best possible understanding of the consequences.

And finally, no major tax reform bill should be adopted without asking what impact it will have--together with our direct programs--on our nation's most helpless citizens--especially the children--and the cities which are trying to help them.

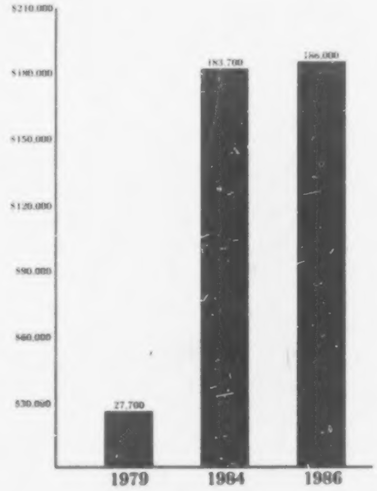
NATIONAL LEAGUE OF CITIES



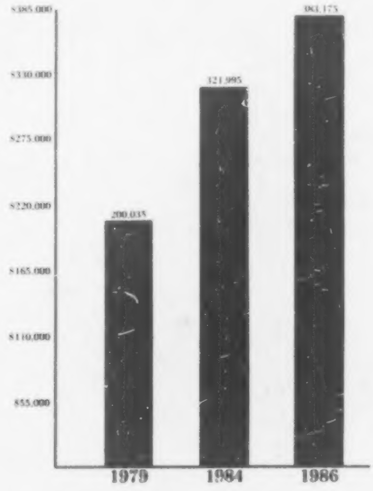
DEFENSE AND SOCIAL SECURITY
Direct Assistance (in millions)



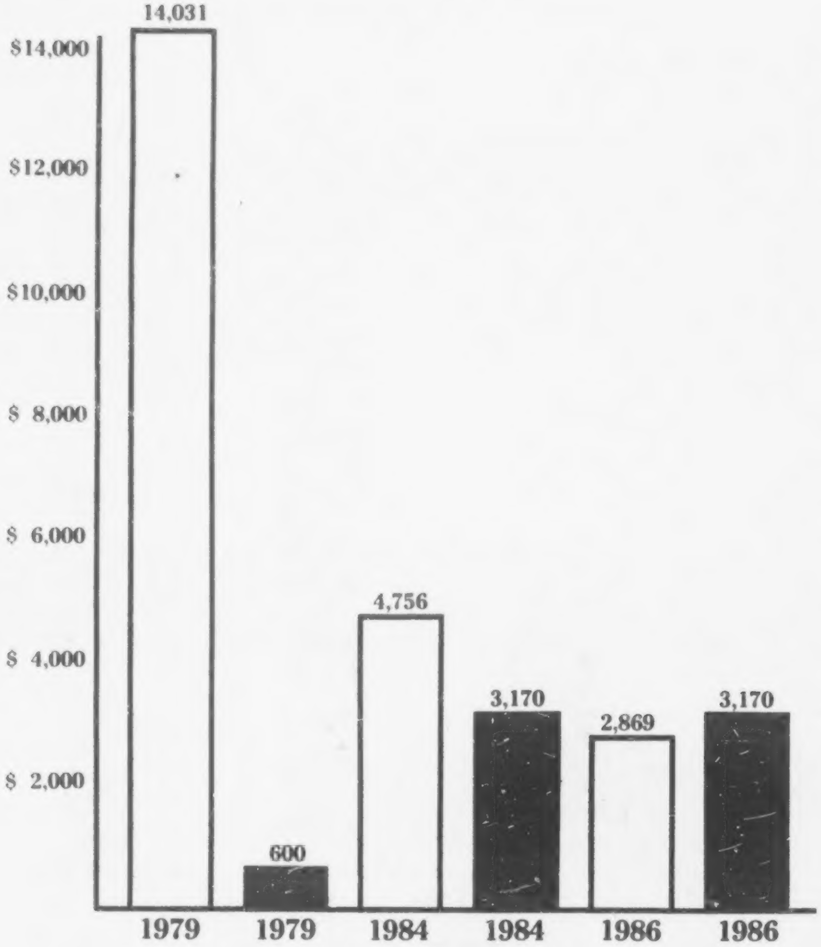
MAJOR CITY PROGRAMS
Direct Assistance (in millions)



FEDERAL DEFICIT
(in millions)



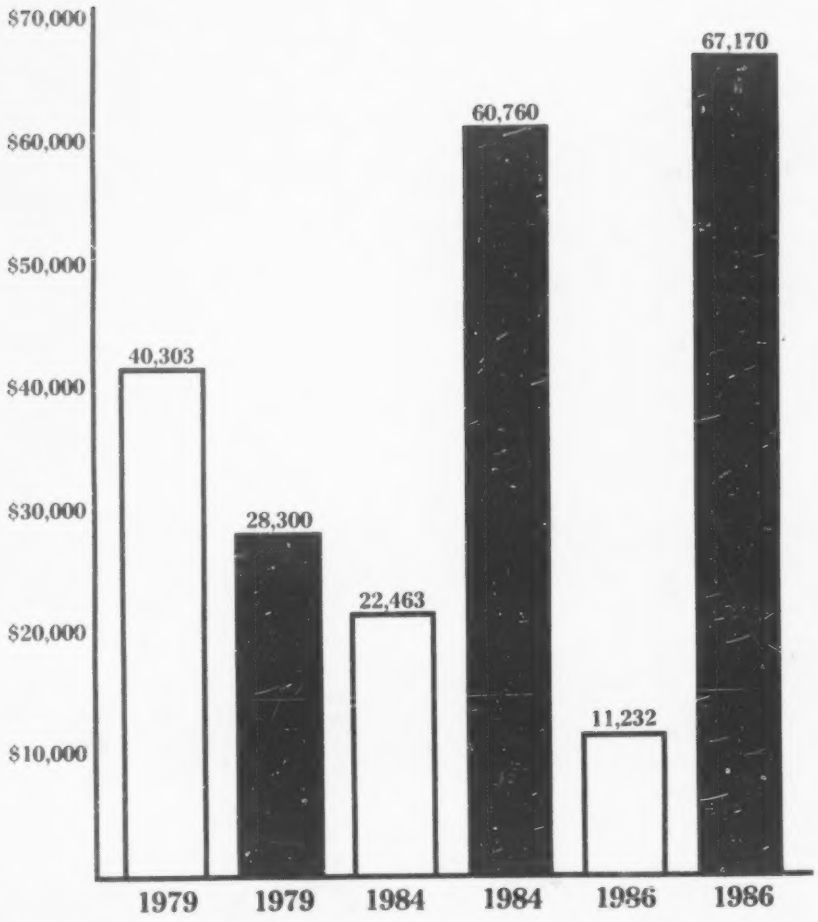
TAX EXPENDITURES
(in millions)



JOBS AND ECONOMIC DEVELOPMENT

Blue-Direct Assistance
Red-Tax Expenditures
(in millions)

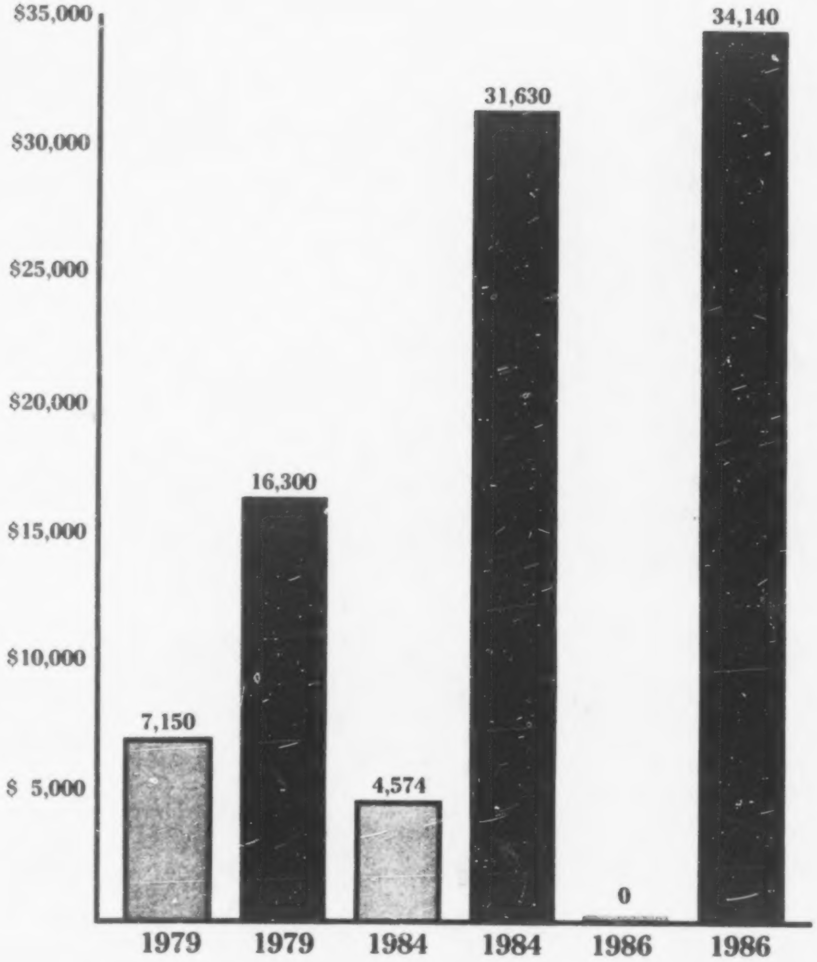
NATIONAL LEAGUE OF CITIES



HOUSING AND COMMUNITY DEVELOPMENT

Blue-Direct Assistance
Red-Tax Expenditures
(in millions)

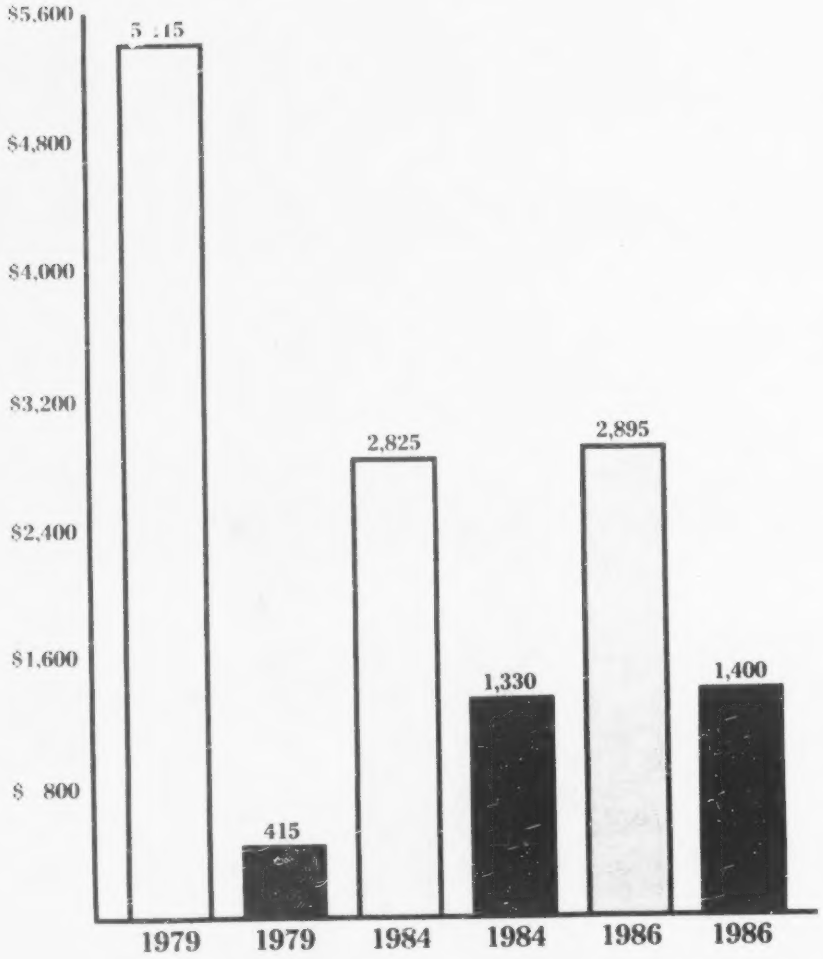
NATIONAL LEAGUE OF CITIES



GENERAL FISCAL ASSISTANCE

Blue-Direct Expenditures
Red-Tax Expenditures
(in millions)

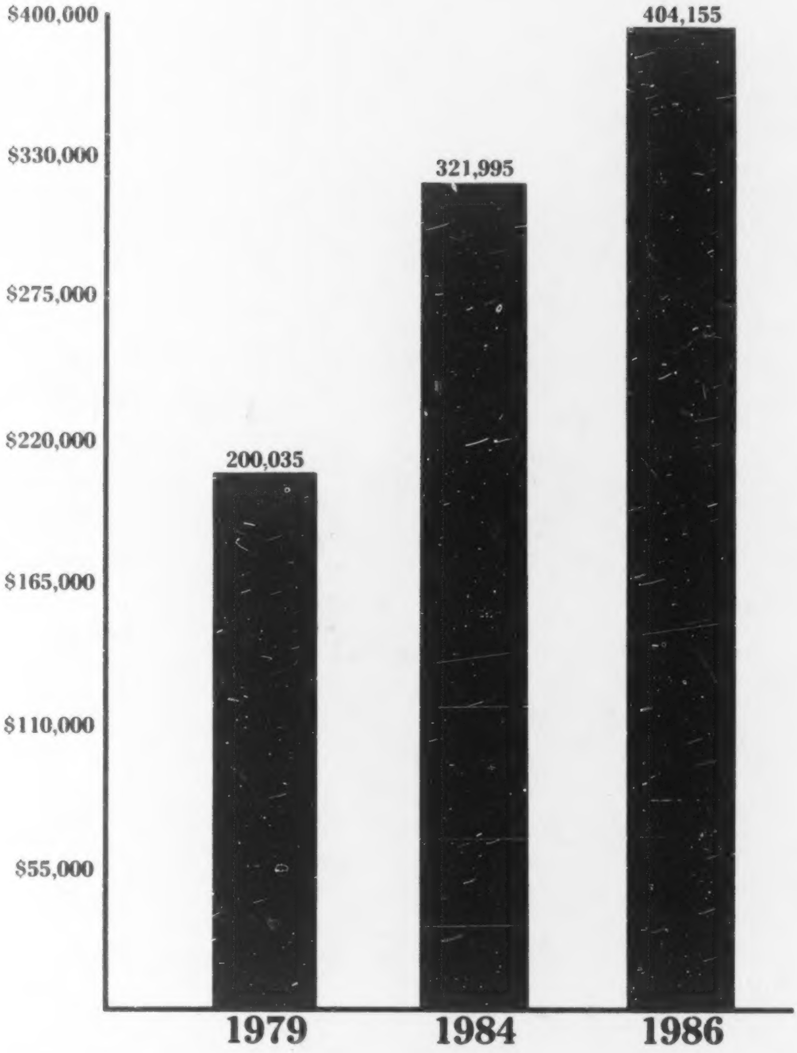
NATIONAL LEAGUE OF CITIES



ENVIRONMENT

Blue-Direct Assistance
Red-Tax Expenditures
(in millions)

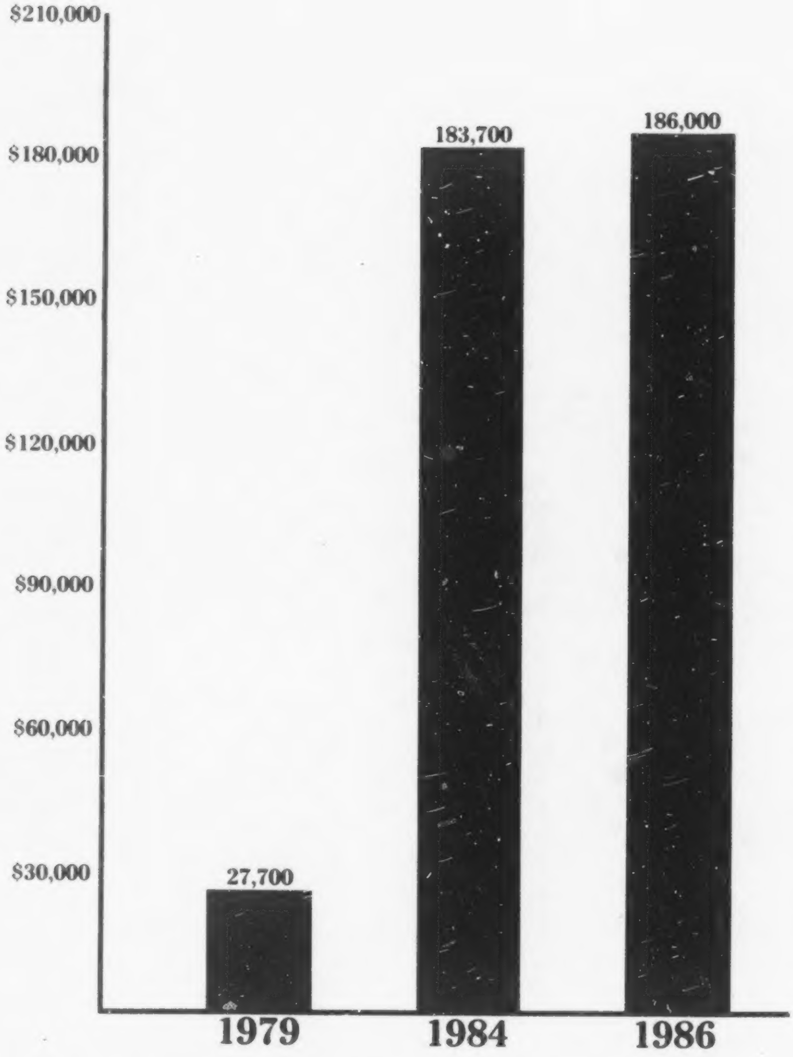
NATIONAL LEAGUE OF CITIES



NATIONAL LEAGUE OF CITIES

TAX EXPENDITURES

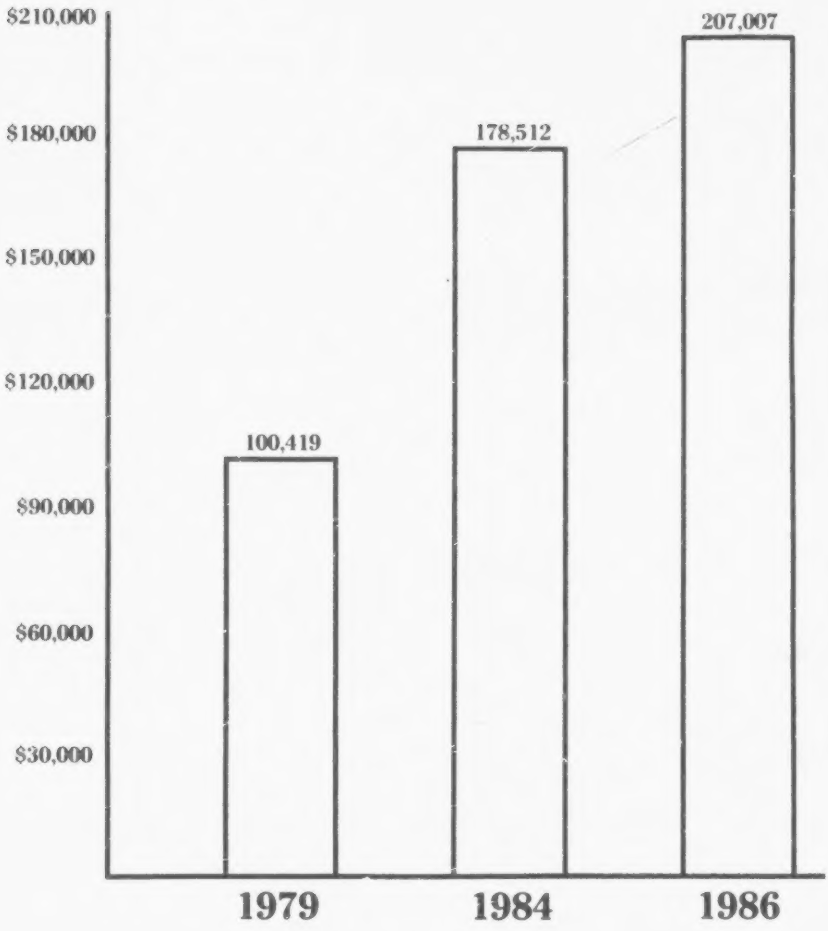
(in millions)



NATIONAL LEAGUE OF CITIES

FEDERAL DEFICIT

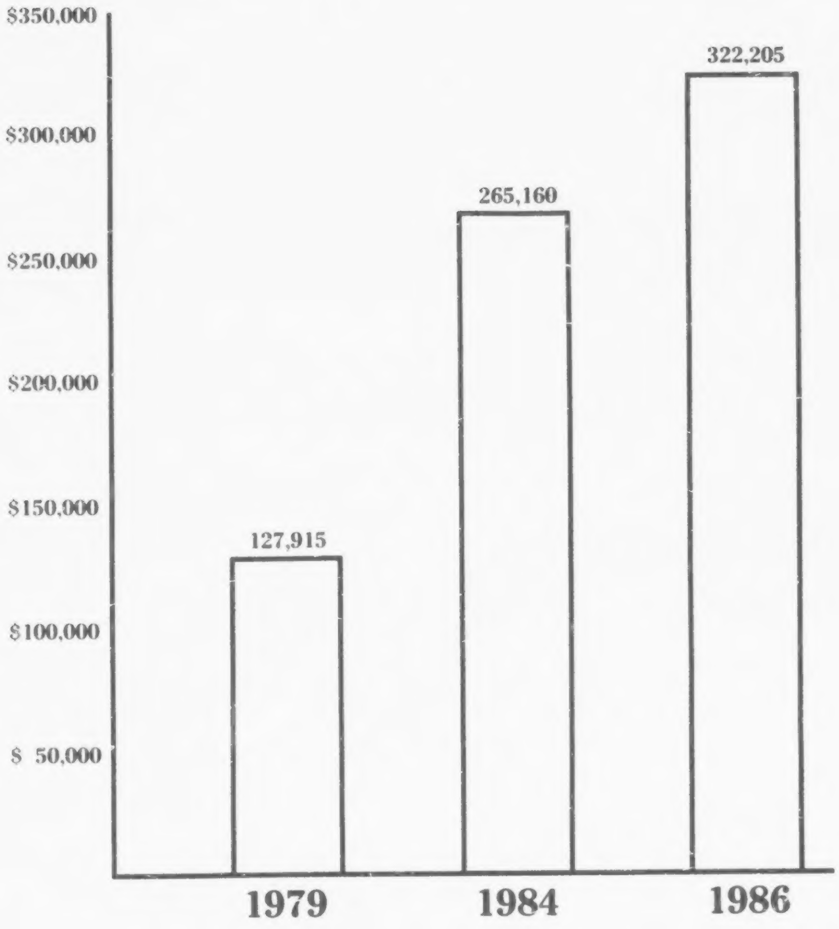
(in millions)



SOCIAL SECURITY

Direct Assistance (in millions)

NATIONAL LEAGUE OF CITIES



DEFENSE

Direct Assistance (in millions)

NATIONAL LEAGUE OF CITIES

THE STATEMENT OF HON. JOHN J. MARCHI, CHAIRMAN, SENATE FINANCE COMMITTEE, NEW YORK STATE SENATE, STATEN ISLAND, NY, ON BEHALF OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES

Senator **Durenberger**. The next witness is the Honorable John Marchi, the chairman of the Senate Finance Committee, New York. Welcome.

Mr. **Marchi**. Thank you, Mr. Chairman, and Senators, members of the panel. I'm here appearing on behalf of the National Conference of State Legislatures and my position is almost identical—I would say identical—with those of my follow panelists. And in addition to that, I would invite your attention and go back very strongly to the institutional aspects. One that Senator Moynihan was pointing to very directly throughout the testimony of previous speakers.

You may remember, Senator, in another forum you pointed to the transcending of the realm of necessity to the realm of freedom. And that depends on institutional stability, and the relationships and the genesis of our free society.

Now we just can't brush cavalierly that genesis and the roots of our society the federalist papers, the commentary that went with it, the experience that went with it; the fact that the United States of America inherited a system of law, a corpus juris, which became the corpus juris of the United States, each depending on the common law as modified by the States so that the Founding Fathers merely established a Supreme Court of the United States as a final arbiter on those Federal questions in such other courts that might be established.

So that the Federal system and the States play a very integral role. I submit, Senators, that this dog will not hunt. This is at total odds with the principle of federalism, as relevant as it is, with the history and the development of the United States. And to bring it in now as a matter of—as an incidental or a part of a tax reform effort, and to ignore completely that which is hopefully a revenue-neutral document—and by that I would have to say, Mr. Chairman and members, that a revenue-neutral document is effective the day it becomes effective. The day, after 24 hours later, it begins to build up its own dynamics. And where are you then?

But this proposal is not institutionally neutral, Mr. Chairman. And that's where its greatest offense lies. Now I heard Mr. Pearlman earlier speaking of low-service States and high-service States and the differential. This is a judgment, a value judgment that we are making. On what basis? As part of a revenue reform or a clarification, fairness and simplicity? Fairness and simplicity? The Piper Cub that I trained on in 1938 was very simple. I had a throttle and a stick, but I wouldn't go to Europe in it.

Life isn't that simple. We live in a society that has developed in the United States the greatest and the most exciting example of a free society amalgamating and bringing in millions of people from all over the world and giving them an opportunity to relate to States. We are the United States of America, not the homogenized States of America. We speak when we are abroad of not going back to America with misty eyes. We say of going back to the States or stateside. Doesn't that tell us, Mr. Chairman? Doesn't that say something about what it's all about? What the Senate of the United States is all about? Two Members from each State, a collegial body resting on two—regardless of sides.

Your treaties. Treaties are ratified by the U.S. Senate. Seventeen Members can frustrate that. You take the 17 lowest populated States of the country and they don't equal the population of New York or California or even Texas if we have mid-decade population projections. This is—you are acting as a collegial body. You represent a cosmos, a totality of experience with courts, with school systems, with all of those things that make up a State. You are ambassadors. You are our hope. And that you would abide the institutional destruction so that that rubble can be used to fashion a brave new world at our expense, where the competition is severest in the provision of important local services—13 million people out there at State and local level, educating, sanitation, police, fire, and all of the multitude of services. Low service. The only growth industry according to the former Secretary of the Treasury will be the moving industry moving people from one State to the other.

This is not a negotiable item. We are talking about fundamentals and not a revenue change. We are talking about something sacred, somethign that's important to us. And you are—you hold our trust. You are the ones that really make the difference. You are the ones that represent us, regardless of your size.

My county of Richmond in Staten Island is equal to almost two or three of your States, but you are here in a different vestment. And Senator Moynihan coming from a populous state is just as jealous of your rights, sir, and just as jealous of the rights of the people of Alaska or Wyoming or wherever they come from. And that's why you also are able, notwithstanding the dimension, the varying dimensions in a collegial body—why you are also able to see national interest. Because you are seeing it in terms of a cosmos, in terms of a total society that provides its own justice, its own basic services and its own interrelationships interrelating as you are in your own body.

Senator **Durenberger**. Senator, thank you very much for your testimony.

Mr. **Marchi**. Our hopes are with you, Senator.

Senator **Durenberger**. Well, I tell you, you got me so excited I hated to cut you off, but we have to move to California. [Laughter.]

[The prepared written statement of Mr. Marchi follows:]

TESTIMONY OF

SENATOR JOHN MARCHI

CHAIRMAN OF THE NEW YORK STATE SENATE FINANCE COMMITTEE

ON BEHALF OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ON THE SUBJECT

OF

FEDERAL TAX REFORM

JULY 25, 1985

Senators, my name is John Marchi. I am Chairman of the New York Senate's Finance Committee. Today I am here as the representative of the National Conference of State Legislatures (NCSL). I serve on both the Federal Budget Committee and the Committee on Federal Taxation of NCSL, and I can assure you that our organization is gravely concerned about the pending proposal to abolish the deductibility of state and local taxes.

NCSL has carefully developed a considered position on federal taxes. It is attached to my testimony. I can summarize its main points briefly:

First, we believe that deductibility is an essential protection which allows us to raise the revenues needed to fulfill our responsibilities. It is not a loophole or a shelter, but a guardian of the federal system itself.

Second, tax exempt municipal bond financing must be maintained if we are to meet the urgent need for infrastructure investment in the public sector. If you want us to be your partners in transportation and environmental projects, you must keep this tool intact.

Finally, federal tax reforms must be properly timed and not made retroactive. You are not acting in a vacuum. State tax codes are thoroughly intertwined with federal law. We will react to your decisions not in conflict with basic principles of Federalism by amending our laws. Please remember that we must move in concert to move productively.

We are here for the purpose of discussing the President's tax proposal for fairness, growth and simplicity. These are worthwhile and difficult objectives, indeed, especially when they must be accomplished within the limitations of revenue neutrality. As members of a deliberative, responsible body, you also know that if you reach that magic moment when an energizing tax code is fairly and simply measurable, and definable numerically, it will only be relevant, in a strict sense, at the moment of adoption.

The day after -- and all the days after that -- would hopefully provide us with a serviceable vehicle for future modifications to adjust to revenue abundance or to yet even greater deficits. That code might initially be designed to be revenue neutral but fiscal urgency may demand immediate changes.

More importantly, however, these White House proposals most emphatically are not institutionally neutral. Indeed, the basic building blocks of the proposed new tax are taken mainly from the rubble of the institutional destruction of the American States.

Professor Andrew McLaughlin of Chicago University told us in 1935 that the 16th Amendment would have greater institutional impact on our lives than any other change since the adoption of the Bill of Rights. Mind you, McLaughlin never had double taxation in mind. As Chief Justice John Marshall once put it, the power to tax is the power to destroy.

The Federalist Papers and subsequent experience demonstrated a sure understanding of the make-up of institutional America. James Madison put it this way: "Each state in ratifying the Constitution, is considered as a sovereign body, independent of all others and can only be bound by its own voluntary act. In this relation, then, the new Constitution, if established, will be a federal and not a national constitution." In those same papers, Alexander Hamilton said, "it is, therefore, as necessary that the state government should be able to command the means of supplying their wants, as the national government should possess the like faculty in respect to the wants of the Union. But an indefinite power of taxation in the latter might, probably would in time, deprive the former of the means of providing for their own necessities, and would subject them entirely to the mercy of the national legislature."

This is not to suggest, however, that our Founding Fathers, in designing a national government, were conferring less than adequate powers to the national government to discharge its responsibilities.

Alexis DeTocqueville understood this duality well, observing that, in its delegated responsibilities, this new country would also operate as a national government but not as an engine of conflict with its basic federal nature.

What is federalism? The Romans knew it and called it "foedus", or, alliance. It was "foedus aequum", or a pact of friendship and mutual assistance with other jurisdictions, and it was a "foedus iniquum", or, malicious evil, or "iniquitas" -- iniquitous -- when it was imposed by a punitive Rome.

Plainly we find an iniquitous federalism wicked and unacceptable.

We Americans take oaths of office and pledge our allegiance not to America but to the United States of America. When we are abroad we speak not of going to America but home, of going stateside, of going to the States.

We are proud of our respective states. We love them, honor them and should not suffer their debasement or defilement.

We have a tendency to forget sometimes that what we call the United States is -- just as the name says -- a union of individual entities -- geographical, ethnic, human -- endowed with a common desire to function as freely and independently as possible. We are nourished and enhanced by the diversity of our states. Our states constitute the fabric, the tapestry of what we call America and what we think of as The American Way.

But I speak today of structural America and the integral part taxes play in maintenance of that structure.

State and local taxes of any kind antedate federal taxes. They accounted for two-thirds (2/3) of all public expenditures in this country until World War II. President Lincoln recognized state and local tax deductibility during the then short-lived experience with a wartime Federal Income Tax. Wisconsin, after adopting a constitutional amendment in 1908, enacted the first income tax in this country. When the Federal Revenue Act was implemented in 1913, the Lincolnesque policy of state and local deductibility was the first order of business and immediately enacted.

Over 70 years later, a change of revolutionary proportion is now advanced and its enactment threatened in a matter of months. Why do we even consider trashing much of our tradition, history and experience -- and so cavalierly?

The validity of -- and the need for -- deductibility was reaffirmed, Senator Daniel Patrick Moynihan reminded us in his March 24 speech to the National League of Cities, by the man who was Chairman of the House Ways and Means Committee during President Lincoln's first term as the nation was embroiled in the Civil War.

As Senator Moynihan put it:

"On July 1, 1862, President Lincoln signed the Revenue Act of 1862, the first national income tax, a 3-to-5 percent tax to finance the Union effort. Section 91 of that Revenue Act said that 'all other national, state and local taxes...shall first be deducted' to determine a taxpayer's liability for the income tax -- and this under the most pressing emergency conditions our country has ever faced.

"The then-chairman of the House Ways and Means Committee was Justin Smith Morrill. ...Chairman Morrill, reporting the tax bill, explained that as a matter of simple logic, the deduction would be necessary both to avoid double taxation and to preserve a principle of Federalism:

> 'It is a question of vital importance that the General Government should not absorb all (the states') taxable resources -- that the accustomed objects of State taxation should, in some degree at least, go

> untouched... Otherwise we might perplex and jostle, if we did not actually crush, some of the most loyal States of the Union.'"

Senator Moynihan made a strong and telling point.

Are those who oppose loss of deductibility shocked merely because of the alleged novelty and newness of the proposal? Not at all, nor should we be.

Great Britain, when confronted by the hardship of imposing an income tax on its subjects in 1916, faced the double impact of national taxes as well as taxes locally imposed.

A Royal Commission was appointed, and on March 20th, 1920, that body recommended "that in respect of income taxes both in the United Kingdom and in a Dominion, in substitution for the existing partial relief there should be deducted from the appropriate rate of the United Kingdom income tax the whole of the rate of the Dominion income tax charged in respect of the same income, subject to the limitation that in no case should the maximum rate of relief given by the United Kingdom exceed one-half of the rate given of the United Kingdom income tax to which the individual taxpayer might be liable."

If the Dominion taxpayer still experienced a loss, then the Dominion was to make up the difference. Much of the Royal Commission's work endured until the Commonwealth Empire changed.

Are you really ready to deny us even Dominion status? Just a few years ago, you passed Revenue Sharing, recognizing tax effort as a basis for that sharing.

We started it in New York and we've stayed with it.

Former Treasury Secretary Regan, a man of great probity and extraordinary ability, apparently dislikes state tax efforts and suggests that some of us, including presumably New Yorkers, vote with our feet by moving to more pliable jurisdictions.

A merry White House scrivener -- who should be fired -- on page 63 of the Presidential Recommendations, in depicting the ultimate in horrible scenarios, said that "in 1982 New Yorkers received an average tax savings of $1,292 from the deduction, whereas itemizers in Wyoming on average saved only $257. In effect, the deduction requires taxpayers in certain communities to subsidize taxpayers in other communities." A great President should not be so poorly advised and so ill-served.

For, does that same White House scrivener also tell us that in 1984, half of all Wyoming tax-levied revenue came from severance taxes, a kind of sales tax on non-replenishable resources? More power to Wyoming, a high tax state, higher even than New York on a per capita basis! But if major severance tax resources were available to New York, we could repeal all our personal income taxes and come out ahead.

I personally have no quarrel with severance taxes at this time but who does the White House scrivener think pays those billions of exportable tax dollars? I say to him: Do not make invidious comparisons to divide and conquer us. Our competitive arena of fifty states will insure manageable tax containment, pitting as it does, labor and cost intensive service-oriented states and localities against one another.

In this connection, bear in mind that there are over 13 million employees at the state and local levels, delivering basic, labor-intensive services, as compared with less than 3 million federal civilian workers.

The severance tax and its relationship to the state-federal structure was discussed in a Congressional report in 1980.

Indeed, it was during Congressional consideration of a bill to limit coal severance taxes that a Minority Representative -- later to become President Reagan's budget director -- spoke up against federal tampering with a state tax, calling it a blow against federalism.

A report was filed by the Republican Minority of the House Commerce Committee, whose minority included David Stockman.

That report, authored in part by then Congressman Stockman said that the proposed limit on the severance tax would create: "a precedent for federal intervention into one of the most basic of the states activities. Under the Constitution, certain fundamental rights have been reserved to the states. One of these rights is the power of the state to tax within its borders. In limiting this power to tax, this legislation seriously calls into question the fundamental relationship between the federal and state governments under our Constitution...nothing less than the independence and sovereignty of the states would be forfeited..."

After we have been crippled by the loss of deductibility, you here in Washington will emerge as the super central state.

And, when, inevitably, we experience a need for additional revenues, may Providence have mercy on the 15, 25 and 35 percenters standing first in line, alone and identifiable.

Senators, this dog won't hunt.

But certainly we are confident that you are able to write a tax plan that will hunt -- a tax plan that will reflect the elements of fairness, simplicity and growth.

The success of that effort will be assured if you stand fast in preserving our historic commitment to the federal system of government.

Thank you.

SUMMARY OF SENATOR JOHN MARCHI'S TESTIMONY FOR STATE LEGISLATORS BEFORE U.S.SENATE FINANCE COMMITTEE JULY 25,1985

-- NCSL believes that deductibility is an essential protection which allows states to raise the revenues needed to fulfill their responsibilities. It is not a loophole or a shelter, but a guardian of the federal system itself.

-- Tax exempt municipal bond financing must be preserved in order to meet urgent public sector infrastructure needs. The loss of deductibility and the so-called "one percent rule" would raise interest costs in all states. Business and personal taxes would go up to pay the higher costs.

-- The basic building blocks of Treasury II are taken from the rubble...of the American States.

-- History is replete with warnings from James Madison, DeTocqueville, and even David Stockman against federal intervention in state revenue functions. There is clear precedent for maintaining deductibility.

-- The United States is a union of individual entities endowed with a desire to function as independently as possible.

-- States should not be pitted against each other. There are sufficient competitive forces among them now to hold down taxes. Severance taxes have come under attack in the past when such efforts were made.

-- If deductibility is destroyed, Washington will emerge as a super central government.

STATEMENT OF ANN KLINGER, MEMBER, BOARD OF SUPERVISORS, MERCED COUNTY, CA, AND MEMBER, NATIONAL ASSOCIATION OF COUNTIES BOARD OF DIRECTORS

Senator DURENBERGER. Ann Klinger, who is a member of the board of supervisors in Merced County, on behalf of NACO.

Ms. KLINGER. Thank you, Mr. Chairman.

I welcome this opportunity to comment on tax reform and to speak for the National Association of Counties. This association supports tax simplification that's fair, and that doesn't diminish the ability of local governments to serve our citizens.

County officials are especially concerned with two provisions of the proposed tax reform bill that repeal a State and local tax deductibility and the redefinition of tax-exempt bonds. Those two proposals have profound implications for county government financing, and they pose a serious threat to our ability to maintain essential citizen services at the local level.

Last week in Orlando, FL at our 50th annual conference, our members adopted an American county platform with a policy of supporting retention of deductibility. I'm going to give you the results of that vote. It was a rollcall vote. A vote of 3,431 and 436. And this was opposing taxing of State and local municipal bonds as well.

I think it's clear that county officials have spoken that this effort on the part of the Treasury Department would disrupt the relationships of Federal, State, and local fiscal relations.

We want to, once again, join the mayors in that. That State and local governments have been lumpted into the broad category of simply yet another special interest group. The taxpayers and citizens that collectively elected the President, voted in the Members of Congress and this committee, are the same ones who elected me an my fellow county officials around the country. Our interest, Mr. Chairman, is quite simply the public interest. Counties across the country are very concerned about the growing Federal deficit. This has been reflected in NACO positions over the years. We have called for freezes in the Federal budget. We have accepted cuts. In fact, by the end of this year, grants and aid to State and local governments will have been reduced by 40 percent since 1980.

We ask now why have we sacrificed if a tax reform effort is passed that contributes to the deficit? Estimates by the Congressional Budget Office, and the soon to be released estimates of the joint tax project show that the President's tax proposal may cost the Treasury billions and that this is ominous in light of the difficult budget negotiations and the $56 billion in program reductions pending for 1986 alone. It just doesn't make sense to pass tax reform measures that are revenue negative.

At present, 73 percent of the dollars for the administration's bill comes from State and local governments. Why this sector? This is too much to swallow in the context of all of the other proposed cuts in grants and aids to State and local governments this year, including general revenue sharing.

In looking at tax reform, NACO urges Congress to consider these positions in light of the following principles: And we are talking about principles here, gentlemen.

No. 1, is federalism. We have supported the President and Congress in their approach to New Federalism. With local responsibility, we must have flexibility and control over our limited resources. In the spirit of American federalism, we hope that the Congress and the President won't break faith with us by infringing on local governments' revenue-raising prerogatives.

PUBLIC-PRIVATE PARTNERSHIPS

Counties support this administration's strong concern for this effort. Don't pull the rug out on us now. Tax-exempt financing has been key to building these partnerships and it's vital in our efforts to repair the infrastructure.

INTERGOVERNMENTAL COOPERATION

The tax reform debate should not create winners and losers among States and localities. And I will just leave it at that.

EQUITY AND FAIRNESS

We've heard very eloquent comments from the mayors and the representative from New York this morning. Tax reform has to take into account the ability to continue providing basic services to the people in this country, and that ranges from education and health care to roads and bridges. The impact of tax reform on home ownership must be heavily weighed. The elimination of State and local tax deductibility would cause an estimated 5-percent drop in property values. And that, in turn, would significantly reduce property tax revenues that finance public services.

This is a bipartisan fight to preserve tax deductibility of State and local taxes. American's counties understand that deductibility is a historical precedent. Deductibility is the financial backbone of our Federal-State-local system of government. Deductibility is not high-tax State versus low-tax State issue. It is an individual, middle class taxpayer issue. Deductibility is right, and it should be preserved.

In summary, Mr. Chairman, I'd like to comment very briefly again on the home ownership issue, especially for young families and elderly taxpayers on fixed incomes. That is really going to become a vanishing American ideal.

Deductibility is not a rich taxpayers issue. One-half of the households earning between $20,000 and $25,000 a year deduct State and local taxes. And two-thirds of all households making between $25,000 and $30,000 use this deduction.

This issue means simply one thing. The loss of deductibility means dramatic cuts in services to people whom we all serve.

Senator **Durenberger**. Thank you very much.

[The prepared written statement of Ms. Klinger follows:]

National Conference of State Legislatures

Office of
State
Federal
Relations

444
North Capitol
Street, N.W.
Suite 203
Washington, D.C.
20001
202/737-7004

President
John T. Bragg
Deputy Speaker
House of Representatives
State of Tennessee

Executive Director
Earl S. Mackey

Statement on Federal Tax Policy

Adopted May 10, 1985

The National Conference of State Legislatures believes that federal tax policy is an integral part of an effective, fair and efficient federal system. With a broad debate already developing on the topic of reforming the federal tax system, the NCSL calls on the Administration and the Congress to enact tax policy which respects state revenue systems. Three points are key to that concern:

1. State and federal taxes are both intended to meet public needs; thus further competition for existing tax bases is inefficient and undesirable. The federal government should continue to rely on the income tax as its best and primary source of revenue. A federal decision to initiate an entirely new tax such as a value added or a consumption tax would result in greater federal administrative costs and increased difficulty for state and local revenue decisions.

2. The deductibility of state and local sales, income and property taxes provides a protection against federal taxation of income used to pay state and local taxes. Such a deduction furthers the national goal of respecting the integrity of state and local tax bases, assuring states and localities of adequate sources of revenue to fulfill their appropriate responsibilities.

3. The right to issue tax-exempt bonds to support capital improvements is fundamental to the capacity of state and local governments to discharge their responsibilities under the federal system. Federal tax policy should not be made which would attempt to limit or encroach upon this source of financing for basic state and local government needs. The state and local government responsibility for these services requires the support of the federal government to assure adequate financing.

Equally important to states, federal tax policy must be in accord with the following:

4. Tax policy must support sound fiscal policy. Continued, predictable economic growth is essential for the fiscal stability of state governments.

5. Adequate revenues are the concern of both the states and the federal government. Whether the responsibility for a public service is shared, purely state or federal, failure to provide the promised and needed service forces an additional burden on other levels of government. Federal revenues must be adequate to support appropriate federal responsibilities.

6. Major federal tax policy proposals often affect state tax systems. Thus, there must be consultation and cooperation between federal and state policy makers. Any proposed changes in federal tax policy must include sufficient time for states to make corresponding changes as desired or needed. In no event should federal tax changes be retroactive, depriving states of duly deliberated and legislated revenues.

7. Since 1980, federal tax rates have declined substantially. However, state tax increases have consistently been needed because of a sluggish economy, additional responsibilities assumed by the states within our federal system, and because states are required to have balanced budgets. Operating surpluses of state governments are not a signal that the federal government should cut back on its responsibilities; rather they are the product of responsible state tax and budgetary policies. Changes in federal tax policy should not penalize states for having acted responsibly these past four years.

The NCSL understands that ease of compliance and effectiveness of enforcement are crucial to tax policy at all levels of government. We further believe that fairness and efficiency are standards needed to guarantee that genuine public needs are met in an equitable manner.

NATIONAL
ASSOCIATION
of
COUNTIES

440 First St. NW, Washington, DC 20001
202/393-6226

STATEMENT OF

THE HONORABLE EARL BAKER, COMMISSIONER
CHESTER COUNTY, PENNSYLVANIA

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

TAX REFORM

ON

BEHALF OF

THE NATIONAL ASSOCIATION OF COUNTIES

JULY 25, 1985
WASHINGTON, D.C.

STATEMENT OF THE HONORABLE EARL BAKER, MEMBER, BOARD OF COMMISSIONERS, CHESTER COUNTY, PENNSYLVANIA, AND CHAIRMAN, NACo TAX AND FINANCE STEERING COMMITTEE.

GOOD AFTERNOON, MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE. I AM EARL BAKER, COMMISSIONER OF CHESTER COUNTY, PENNSYLVANIA. I AM HERE TODAY ON BEHALF OF THE NATIONAL ASSOCIATION OF COUNTIES (NACo)* AND AS CHAIR OF THE NACo TAX AND FINANCE STEERING COMMITTEE, EXTEND MY APPRECIATION FOR THE OPPORTUNITY TO COMMENT ON TAX REFORM.

COUNTIES NATIONWIDE SUPPORT FAIR TAX SIMPLIFICATION - BUT NOT AT THE EXPENSE OF LOCAL GOVERNMENTS, AND OUR ABILITY TO SERVE OUR CITIZENS. THIS IS EVIDENCED IN THE ROLL CALL VOTE TAKEN LAST WEEK AT NACo'S NATIONAL CONVENTION ON STATE AND LOCAL TAX DEDUCTIBILITY. COUNTY OFFICIALS VOTED 3,456 TO 523 TO MAINTAIN THIS PROVISION OF THE TAX CODE.

IN LOOKING AT TAX REFORM, NACo URGES CONGRESS TO CONSIDER THE FOLLOWING PRINCIPLES:

1. FEDERALISM

WE HAVE SUPPORTED THE PRESIDENT AND THIS CONGRESS IN THEIR APPROACH TO NEW FEDERALISM. WE HAVE ALWAYS BELIEVED IN LOCAL RESPONSIBILITY. BUT, WITH RESPONSIBILITY, WE MUST HAVE FLEXIBILITY AND CONTROL -- WHEN LIMITS ARE IMPOSED FROM ABOVE, RATHER THAN FROM

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* THE NATIONAL ASSOCIATION OF COUNTIES IS THE ONLY NATIONAL ORGANIZATION REPRESENTING COUNTY GOVERNMENT IN THE UNITED STATES. THROUGH ITS MEMBERSHIP, URBAN, SUBURBAN AND RURAL COUNTIES JOIN TOGETHER TO BUILD EFFECTIVE, RESPONSIVE COUNTY GOVERNMENT. THE GOALS OF THE ORGANIZATION ARE TO: IMPROVE COUNTY GOVERNMENT; SERVE AS THE NATIONAL SPOKESMAN FOR COUNTY GOVERNMENT; ACT AS A LIAISON BETWEEN THE NATION'S COUNTIES AND OTHER LEVELS OF GOVERNMENT; ACHIEVE PUBLIC UNDERSTANDING OF THE ROLE OF COUNTIES IN THE FEDERAL SYSTEM.

WITHIN, THE ABILITY TO MANAGE WELL BECOMES A DIFFICULT TASK. THIS IS NOT WHAT AMERICAN FEDERALISM IS ABOUT AND WE HOPE THAT THE PRESIDENT AND CONGRESS WILL NOT BREAK FAITH WITH US.

2. PUBLIC - PRIVATE PARTNERSHIPS

COUNTIES NATIONWIDE HAVE SUPPORTED THIS ADMINISTRATION'S STRONG CONCERN FOR PUBLIC - PRIVATE PARTNERSHIPS. TAX EXEMPT FINANCING HAS BEEN KEY TO BUILDING THESE PARTNERSHIPS - SO IMPORTANT TO THE VITALITY OF OUR COMMUNITIES AND RESIDENTS.

3. INTERGOVERNMENTAL COOPERATION

THE TAX REFORM DEBATE SHOULD NOT DEFINE WINNERS AND LOSERS AMONG STATES AND LOCALITIES. THE ENTIRE FEDERAL SYSTEM HINGES UPON A DELICATE INTERLACING OF MANY INTERSTATE SUBSIDIES, AND PER CAPITA INCOME FORMULAS. WE RISK PULLING APART THE ENTIRE NATION IF WE FOCUS ON STATE-BY-STATE DIFFERENCES. WE SHOULD, INSTEAD, DIRECT OUR ENERGIES TO THE STRENGTHS OF EACH STATE, AND REVEL IN THE DIVERSITY THAT MAKES THIS COUNTRY GREAT.

4. EQUITY AND FAIRNESS

THE ABILITY TO CONTINUE PROVIDING THE BASIC SERVICES TO THE PEOPLE OF THIS COUNTRY, FROM EDUCATION TO HEALTH CARE, MUST BE TAKEN INTO ACCOUNT. AND THE IMPACT OF TAX REFORM ON HOME OWNERSHIP AND PARTICULARLY ELDERLY HOMEOWNERS MUST BE HEAVILY WEIGHED. IT HAS BEEN ESTIMATED THAT THE ELIMINATION OF STATE AND LOCAL TAX DEDUCTIBILITY WOULD COST A 5% REAL DROP IN PROPERTY VALUES; AND THAT THIS IS THE LARGEST SINGLE DEDUCTION USED BY ELDERLY HOMEOWNERS.

WITH THOSE PRINCIPLES IN MIND, I WILL COMMENT ON TAX EXEMPT BONDS AND THE ELIMINATION OF STATE AND LOCAL TAX DEDUCTIBILITY. THE COMBINATION OF THESE PROVISIONS WILL HAVE DIRECT AND SUBSTANTIAL EFFECTS ON COUNTIES. ELIMINATING THE DEDUCTIBILITY OF STATE AND LOCAL TAXES WOULD INCREASE TAXPAYER RESISTANCE AND WOULD MAKE IT HARDER FOR STATE AND LOCAL GOVERNMENTS TO MAINTAIN OR INCREASE CURRENT TAX RATES AT A TIME WHEN OTHER RESOURCES, ESPECIALLY FEDERAL GRANTS, ARE DECLINING. AT THE SAME TIME, THE COST OF BORROWING FOR STATE AND LOCAL GOVERNMENT ENTERPRISES WOULD LIKELY INCREASE, DUE TO SUCH ACTIONS AS CURBING THE TAX-EXEMPT STATUS OF CERTAIN TYPES OF GOVERNMENT ISSUED BONDS. THEREFORE, MORE AND MORE PRESSURE WOULD BE PLACED ON DEBT CEILINGS AND PROPERTY TAXES.

IN THIS REGARD, I NOTE THAT MOUNTING REVENUE AND FINANCING PRESSURES ARE ALREADY CAUSING GOVERNMENTS TO ACCEPT POORER DEBT STRUCTURES AND DETERIORATING BALANCE SHEETS.

MUNICIPAL BONDS:

JUST AS FEDERAL DEBT IS EXEMPT FROM LOCAL TAXES, COUNTY GOVERNMENTS VIGOROUSLY OPPOSE ANY ACTION WHICH WOULD DIRECTLY OR INDIRECTLY TAX UNDER THE FEDERAL INCOME TAX, INTEREST ON STATE OR LOCAL GOVERNMENT MUNICIPAL BONDS, OR WOULD PLACE THESE BONDS IN AN INFERIOR COMPETITIVE POSITION WITH FEDERAL DEBT INSTRUMENTS AND CORPORATE SECURITIES.

THE ONE PERCENT PROVISION AS AN ELIGIBILITY TEST FOR EXEMPTION OF INTEREST ON MUNICIPAL BONDS WOULD SERIOUSLY DIMINISH LOCAL GOVERNMENTS' ABILITY TO WORK WITH THE PRIVATE SECTOR TO ENSURE ECONOMIC VITALITY. IT HAS BEEN ESTIMATED BY THE PUBLIC SECURITIES ASSOCIATION THAT THIS PROVISION WOULD NOT ONLY ELIMINATE PRIVATE-PURPOSE TAX-EXEMPT BONDS, BUT WOULD RENDER 62-80% OF ALL BONDS TAXABLE. THIS WILL AFFECT A BROAD ARRAY OF SERVICES AND COMMUNITY NEEDS, FROM EMPLOYMENT OPPORTUNITIES AND HOSPITAL CARE TO INFRA-STRUCTURE WHICH IS A NECESSARY FOUNDATION FOR ECONOMIC GROWTH AND ENVIRONMENTAL PROTECTION. WITHOUT THESE NECESSITIES, LOCAL ECONOMIES WILL FALTER AND THE QUALITY OF LIFE AND OF PUBLIC SERVICES WILL DETERIORATE.

THIS IS NOT TO SAY THAT THERE HAVEN'T BEEN ABUSES. NACo HAS ALWAYS SUPPORTED POLICIES, PROGRAM WIDE, THAT CALL FOR EFFICIENT AND STREAMLINED FINANCING AND DELIVERY APPROACHES. WHERE THERE HAVE BEEN ABUSES -- AND THEY ARE NOT ENDEMIC TO INDUSTRIAL DEVELOPMENT BONDS -- WE HAVE ALWAYS WORKED WITH CONGRESS AND THE ADMINISTRATION TO CORRECT PROBLEMS.

NACo RECENTLY PASSED POLICY THAT RECOGNIZES THESE CONCERNS. COUNTIES NATIONWIDE BELIEVE THAT THE TAX-EXEMPT NATURE OF MUNICIPAL BONDS SHALL BE SAFEGUARDED, PARTICULARLY WHERE BOND PROCEEDS ARE USED TO FINANCE BASIC GOVERNMENT FUNCTIONS AND SERVICES OR PROVIDE THOSE SERVICES THROUGH A COST-EFFECTIVE PUBLIC/PRIVATE SHARING OF EQUITY OR MANAGEMENT RESPONSIBILITY: WHERE THE BONDS ARE BACKED BY THE FULL FAITH AND CREDIT OF LOCAL GOVERNMENT; WHERE PROCEEDS ARE USED FOR ENVIRONMENTAL FACILITIES REQUIRED TO MEET FEDERAL OR STATE

MANDATES; OR WHERE BOND PROCEEDS ARE USED IN A MANNER WHICH WILL PROVIDE AFFORDABLE MULTI-FAMILY HOUSING: HEALTH CARE FACILITIES WHICH SERVE THE INDIGENT: OR WILL GENERATE DEVELOPMENT AND EMPLOYMENT IN ECONOMICALLY DISTRESSED AREAS AND ANY OTHER PROJECTS IN THE PUBLIC INTEREST AS DETERMINED BY THE LOCAL GOVERNING BODY.

HOSPITALS PROVIDE AN EXAMPLE IN WHICH TAX-EXEMPT BONDS HAVE BEEN USED BY GOVERNMENTS AND PRIVATE ENTITIES FOR A PUBLIC PURPOSE. MANY COUNTIES DO NOT OWN THEIR OWN HOSPITALS AND MUST HAVE A WAY TO ENSURE THAT NECESSARY HEALTH CARE FACILITIES ARE AVAILABLE AND OPEN TO ALL CITIZENS. COUNTIES ARE ALSO BEGINNING TO LOOK AT TYING INDIGENT CARE NEEDS TO TAX EXEMPT FINANCING FOR HOSPITALS, ENSURING PATIENT CARE AND PROHIBITING THE "DUMPING" OF UNINSURED PATIENTS -- A PRACTICE WHICH HAS BECOME MORE PREVALENT WITH THE CUTBACKS IN PUBLIC HEALTH INSURANCE. IN ADDITION, WHEN A GOVERNMENT USES TAX-EXEMPT BONDS TO FINANCE PRIVATELY OWNED OR OPERATED PUBLIC FACILITIES, THE COSTS TO USERS ARE REDUCED. THIS SHOULD NOT BE OVERLOOKED IN THE CONTEXT OF RISING HEALTH CARE COSTS AND THE OVERALL EFFECT ON OUR ECONOMY.

MR. CHAIRMAN, IT IS CLEAR THAT THE TAX BILL PROVISIONS REGARDING THE TAX EXEMPT FINANCING WOULD ACTIVELY DISCOURAGE NEEDED INVESTMENT IN OUR PUBLIC ASSETS AND WELFARE.

STATE AND LOCAL TAX DEDUCTIBILITY:

THE PROVISION IN THE FEDERAL INCOME TAX CODE THAT ALLOWS TAXPAYERS TO DEDUCT THEIR STATE AND LOCAL TAX PAYMENTS FROM THEIR FEDERAL TAXABLE INCOME IS A FUNDAMENTAL STATEMENT OF THE HISTORICAL RIGHT OF STATE AND LOCAL GOVERNMENTS TO RAISE REVENUES AND TAXPAYERS

NOT TO BE SUBJECTED TO DOUBLE TAXATION. EVEN AT THE HEIGHT OF THE CIVIL WAR WHEN THE EMERGENCY FEDERAL INCOME TAX WAS ENACTED, LOCAL TAXES WERE DEDUCTED BEFORE COMPUTING INDIVIDUAL LIABILITY. WHEN THE CURRENT FEDERAL INCOME TAX WAS INTRODUCED IN 1913, STATE AND LOCAL DEDUCTIBILITY WAS AND HAS REMAINED A KEY PROVISION.

DEDUCTIBILITY PRESERVES THE ABILITY OF STATE AND LOCAL GOVERNMENTS TO RAISE REVENUES AND TO PROVIDE SERVICES, PROMOTES EQUITY IN THE FEDERAL TAXING SYSTEM, AVOIDS EXCESSIVE CUMULATIVE FEDERAL/STATE/LOCAL INCOME TAX RATES, AND HELPS PRESERVE THE HISTORIC INDEPENDENCE OF STATE AND LOCAL GOVERNMENTS.

PROPERTY TAXES:

THE PROPERTY TAX IS BY FAR THE LARGEST SINGLE REVENUE SOURCE FOR MOST COUNTY GOVERNMENTS. OVER 80% OF COUNTY REVENUE IS DERIVED FROM PROPERTY TAXES. COUNTY GOVERNMENTS USE THIS TAX BASE TO FUND AN ARRAY OF ESSENTIAL SERVICES INCLUDING EDUCATION, HEALTH CARE, ENVIRONMENTAL PROTECTION, INFRASTRUCTURE, AND LAW ENFORCEMENT.

THE DEMAND FOR THESE SERVICES IS EXPANDING, YET PROPERTY TAXES ALREADY ARE RESTRAINED. TAXPAYER REVOLTS, LIKE PROPOSITION 13 IN CALIFORNIA AND PROPOSITION 2-1/2 IN MASSACHUSETTS, HAVE OCCURRED IN THIRTY-FIVE STATES -- INCLUDING MY OWN -- ARE RESTRICTED FROM RAISING TAXES BY STATE LAWS WHICH PLACE CEILINGS ON PROPERTY TAX INCREASES.

NATIONWIDE POLLS SHOW THAT THIS TAX IS THE MOST DISLIKED -- BUT IT IS THE ONE TAX ALMOST ALL LOCAL GOVERNMENTS HAVE DIRECT CONTROL OVER. LOSS OF DEDUCTIBILITY MAKES COUNTIES' MAJOR REVENUE SOURCE

MORE UNATTRACTIVE AND MORE SUSCEPTIBLE TO TAXPAYER REVOLTS. THIS FURTHER ERODES OUR ABILITY TO PROVIDE AND FINANCE CAPITAL NEEDS.

SOME STUDIES HAVE ESTIMATED THAT THE ELIMINATION OF DEDUCTIBILITY COULD CAUSE A 5% DROP IN PROPERTY VALUES THREATENING A PRINCIPAL SOURCE OF FAMILY SAVINGS -- EQUITY IN THEIR HOMES. SUCH A DROP IN VALUES WOULD ALSO FORCE LOWER PROPERTY TAX ASSESSMENTS WHICH WOULD OBVIOUSLY HAVE A NEGATIVE IMPACT ON LOCAL GOVERNMENT REVENUES. NOT ONLY WILL WE BE CONSTRAINED FROM FINDING NEW REVENUES TO MEET THE EVER GROWING DEMANDS PLACED ON LOCAL GOVERNMENTS -- BUT THIS CURTAILMENT OF REVENUES WOULD MAKE IT MORE DIFFICULT FOR US TO MAINTAIN WHAT WE DO HAVE.

CREDIT RATINGS:

MOODY'S INVESTOR SERVICE AND MERRILL LYNCH PROJECT THAT THIS PROVISION OF THE TAX PLAN HOLDS SERIOUS CONSEQUENCES FOR STATE/LOCAL CREDIT. REDUCED ABILITY TO RAISE NEEDED REVENUE COULD CAUSE SHARP DOWNGRADING IN MUNICIPAL CREDIT RATINGS, HENCE HIGHER COSTS OF FINANCING FOR COUNTIES. OUR ABILITY TO AFFECT ECONOMIC BEHAVIOR AND TO BUILD PUBLIC-PRIVATE PARTNERSHIPS -- A PHILOSOPHY OF THIS ADMINISTRATION WHICH COUNTIES WHOLEHEARTEDLY SUPPORT -- WILL BE GREATLY DIMINISHED. THESE PROJECTIONS ARE EVEN MORE SERIOUS WHEN THE LOSS OF DEDUCTIBILITY IS CONSIDERED, TOGETHER WITH OTHER PROVISIONS OF THE TAX BILL, SEVERELY RESTRICTING LOCAL GOVERNMENT GENERAL OBLIGATION AND INDUSTRIAL DEVELOPMENT BONDS.

PUBLIC SERVICES:

COUNTIES ARE CLOSEST TO THE PEOPLE AND ARE OFTEN THE PROVIDERS OF LAST RESORT. WE CURRENTLY FINANCE BILLIONS OF DOLLARS IN NECESSARY SERVICES AND CARE. BUT IF OUR HANDS ARE FURTHER TIED WHEN IT COMES TO MONEY TO PAY THE BILLS -- PUBLIC EDUCATION, POLICE AND FIRE, INFRASTRUCTURE NEEDS AND BASIC HEALTH AND HUMAN SERVICES WILL BE SERIOUSLY UNDERMINED.

FOR EXAMPLE, EDUCATION IS THE LARGEST SINGLE EXPENSE OF STATE AND LOCAL GOVERNMENTS, COMPRISING 40% OF TOTAL EXPENDITURES IN 1982. THE TAX DEDUCTIBILITY PROVISION ACCOUNTS FOR \$12.7 BILLION THAT IS SPENT ON ELEMENTARY AND SECONDARY SCHOOLS AND \$3.8 BILLION THAT IS APPROPRIATED FOR HIGHER EDUCATION. THE CONGRESSIONAL RESEARCH SERVICE ESTIMATES THAT FOR EVERY \$1.00 OF REVENUE THAT WOULD BE GENERATED BY REPEAL OF THIS DEDUCTION, STATE AND LOCAL GOVERNMENTS WOULD BE FORCED TO CUT THEIR BUDGETS BY 47 CENTS. UNDOUBTEDLY, EDUCATION WOULD BEAR A SUBSTANTIAL PORTION OF ANY LOSS IN REVENUE TO STATE AND LOCAL GOVERNMENTS RESULTING FROM FEDERAL REPEAL OF THIS DEDUCTION.

THE ADMINISTRATION MAINTAINS THAT THE TAX PACKAGE PROVIDES RELIEF TO LOW INCOME PEOPLE. HOWEVER, IN ORDER TO FULLY WEIGH THE IMPACT THAT TREASURY II WOULD HAVE ON LOW INCOME AND POOR PEOPLE WE MUST LOOK, NOT ONLY AT TAXES THAT PERSONS WITH MODEST INCOMES ARE REQUIRED TO PAY, BUT ALSO AT SERVICES TO POOR PEOPLE THAT ARE LIKELY TO BE CURTAILED AS A RESULT OF THE ELIMINATION OF STATE AND LOCAL TAX DEDUCTIBILITY. IN MANY INSTANCES, PERSONS WHO PAY STATE

AND LOCAL TAXES RECEIVE LITTLE IF ANY DIRECT BENEFIT FROM SERVICES FINANCED THROUGH THESE TAXES. THESE FUNDS ARE REDISTRIBUTED TO PERSONS WHO ARE IN NEED OF HEALTH AND WELFARE ASSISTANCE, MENTAL HEALTH, AND OTHER ESSENTIAL SERVICES.

INTERSTATE ISSUES:

ADVOCATES OF THE ADMINISTRATION'S TAX REFORM PROPOSAL ARGUE THAT IT IS UNFAIR FOR TAXPAYERS IN LOW TAXING STATES TO SUBSIDIZE BUDGETS IN HIGH TAXING STATES. THIS POSITION OVERLOOKS THE FACT THAT SOME COUNTIES WITH HIGH TAX RATES TRADITIONALLY HAVE HAD A DISPROPORTIONATE SHARE OF LOW INCOME AND INDIGENT PERSONS WHO ARE IN NEED OF A WIDE RANGE OF SERVICES WHICH ARE FUNDED WITH REVENUE DERIVED FROM STATE AND LOCAL TAXES. FURTHERMORE, ANY DISCUSSION OF SUBSIDIES BETWEEN STATES MUST TAKE INTO ACCOUNT THE NET IMPACT OF ALL INTERSTATE SUBSIDIES IN THE TAX CODE, PARTICULARLY THOSE BENEFITTING ENERGY PRODUCING STATES. IN FACT, AS THOSE STATES FACE CRISES IN THEIR TRADITIONAL INDUSTRIES AND FIND THAT THEY MUST TURN TO ALTERNATIVE SOURCES OF REVENUE, THEY WILL FIND GREATER RESISTANCE TO DOING SO WITH THE LOSS OF DEDUCTIBILITY.

FAIRNESS:

THE DEDUCTIBILITY OF PROPERTY TAXES HAS A SPECIAL IMPORTANCE WHICH HASN'T BEEN CLEARLY ENOUGH STATED IN THIS TAX DEBATE. THE FACT THAT PEOPLE CAN DEDUCT THE COST OF THEIR PROPERTY TAXES MAKES

IT POSSIBLE FOR MANY MILLIONS OF AMERICANS TO OWN A HOME. HOME OWNERSHIP AND THE SENSE OF NEIGHBORHOOD AND COMMUNITY PRIDE IT BUILDS ARE FUNDAMENTAL TO OUR AMERICAN WAY OF LIFE. MOST HOMEOWNERS MADE THE DECISION TO BUY A HOME -- THE SINGLE BIGGEST FINANCIAL COMMITTMENT THEY WILL EVER MAKE -- BASED ON THE KNOWLEDGE THAT THEIR PROPERTY TAXES WOULD BE DEDUCTIBLE. IN LITERALLY MILLIONS OF CASES, THE PRESIDENT'S PROPOSAL WOULD SEVERELY DISRUPT INDIVIDUAL FAMILIES' PERSONAL FINANCIAL PLANS.

DEDUCTIBILITY OF STATE AND LOCAL TAXES OFTEN IS PERCEIVED AS PROVIDING A TAX BENEFIT TO UPPER INCOME TAXPAYERS. TO VIEW IT IN THAT LIGHT OVERLOOKS THE FACT THAT REPEAL OF THIS DEDUCTION WOULD INCREASE THE TAX LIABILITY OF MANY LOW AND MIDDLE INCOME TAXPAYERS. THERE ARE ALMOST AS MANY HOMEOWNERS AS RENTERS WITH INCOMES BELOW $10,000 AND THERE ARE SUBSTANTIALLY MORE HOMEOWNERS THAN RENTERS WITH INCOMES BETWEEN $10,000 AND $20,000. MANY LOW INCOME HOMEOWNERS ARE ELDERLY AND ON FIXED INCOMES. ONE-HALF OF THE HOUSEHOLDS MAKING BETWEEN $20,000 AND $25,000 A YEAR DEDUCT STATE AND LOCAL TAXES, AND TWO-THIRDS OF ALL HOUSEHOLDS MAKING BETWEEN $25,000 AND $30,000 USE THIS DEDUCTION. MANY WHO HAVE JUST MANAGED TO FIT THE COST OF HOME OWNERSHIP WITHIN THEIR FAMILY BUDGET, WILL NOW FIND THEY ARE UNABLE TO DO SO. COUNTLESS OTHER FAMILIES AND YOUNG COUPLES HOPING TO BE ABLE TO AFFORD A FIRST HOME WILL FIND THEMSELVES HOPELESSLY PRICED OUT OF THE MARKET. MANY SENIOR CITIZENS FOR WHOM THE PROPERTY TAX IS THE LARGEST PART OF THEIR MONTHLY COST OF HOME OWNERSHIP, WILL NOW FIND THEY SIMPLY CANNOT MAKE ENDS MEET. FOR THESE TAXPAYERS, LOSS OF THIS DEDUCTION WOULD MAKE PROPERTY TAXES MORE REGRESSIVE AND THEREFORE MORE ONEROUS.

IN SUMMARY, NACo ASKS THAT THE COMMITTEE MODIFY THE TAX EXEMPT BOND PROVISIONS AS I HAVE OUTLINED AND TO RETAIN STATE AND LOCAL TAX DEDUCTIBILITY. WE LOOK FORWARD TO WORKING WITH YOU, MR. CHAIRMAN, ON THESE ISSUES AND OVERALL TAX REFORM.

I WOULD BE PLEASED TO ANSWER ANY QUESTIONS.

STATEMENT OF JONATHAN T. HOWE, SECOND VICE PRESIDENT, NATIONAL SCHOOL BOARDS ASSOCIATION, ROCKFORD, IL

Senator DURENBERGER. Our final witness is Jonathon Howe, second vice president of the National School Boards Association.

Mr. HOWE. Thank you, Mr. Chairman.

As a school board member in Northbrook, IL, I am pleased to represent over 95,000 school board members throughout this country. We are the ones in the trenches, who are probably the most accountable to our local citizenry for what goes on in the school. And, obviously, public education today is the largest consumer of State and local taxes, which are generated in our country today.

The deduction for State and local taxes is taken by more taxpayers in this country than any other single deduction. Despite the eloquence of other witnesses who may be in favor of the President's proposal to withdraw this deduction, it is, nonetheless, one involuntary tax shelter that is available to all citizens in this country. It is not a rich man's deduction. In fact, what some say, the rich aren't paying taxes, so really this shouldn't be of too much concern to them or providing an unfairness in what they are paying.

As other witnesses have said, more than 72 percent of the taxpayers earning income between $25,000 and $30,000 per year utilize this deduction. It was interesting to hear the comments in response to Senator Bradley's question about the role of the nonitemizers in the governance of what is going to take place in the local community. The argument has been made that there is not indirect impact upon the nonitemizer. Well, I dare say there will be a very dramatic impact upon the nonitemizer if the itemizers suddenly lose the opportunity to have the deductibility of State and local taxes.

Once there is a removal of this opportunity of taking this deduction for the payment of involuntary taxes—once this removal takes place, what we will find, I am sure, is the same reaction that we have in school bond referenda or in any type of local tax issue. That once the taxpayers, especially those 72 percent who don't have children in public schools, are given a choice as to whether they are going to make this contribution to public education through an increased tax rate, or the maintenance of a tax budget for public education, they are going to think twice. And those parents who are the nonitemizers whose children get many of the benefits of the State and local taxes that are generated are going to lose. Their children will be directly impacted by what has taken place.

I think as the mayor of Cleveland pointed out, the difference of a 1,000 votes can make the difference in the passage or failure of a school bond referendum.

When we see what is happening within the local schools, that education is a primary object of this country, locally, State and nationally, we must do what we can at all levels of government to provide incentive and support. If we go and look at the retooling of public education as being a vital issue and a priority for this country, to take away the one deduction that is available for people who do support public education through those State and local taxes is to take away an opportunity for us to maximize our potentials in public education at the local level.

We submit to you that the repeal of this deduction, when viewed in conjunction with additional proposals to curtail the issuance by States and local governments of tax-exempt bonds, eliminating early issuance, advance refunding and arbitrage, will deal a blow to school districts in which we are going to be hard pressed to be able to recover.

As a result of this, and to provide more definitive information than our mere hypothesis, the National School Boards Association is conducting a study to determine the result of tax simplification. NSBA's survey will indicate clearly whether the brunt of this proposal will fall on those who will continue to enjoy the fruits of the synthetic tax credits and deductions or those who can afford no more than that which they may be acquired and through their tax dollars. The results of that survey will be available to this committee no later than September 15, and we would urge you to give consideration to that survey, and to have the opportunity to consider it when it is completed. We hope it would buoy up the position that has been taken by the witnesses of this panel that the continuation of the deduction for State and local taxes is extremely important to the fabric of our society and to the concept of federalism, which has been discussed here this morning.

Thank you.

Senator DURENBERGER. Thank you very much.

[The prepared written statement of Mr. Howe follows:]

NSBA
FEDERAL RELATIONS

Dr. Mack J. Spears
President

Thomas A. Shannon
Executive Director
Michael A. Resnick
Associate Executive Director
Lynne Glassman
Director, Network Operations
Katharine L. Herber
Legislative Counsel
Edward R. Kealy
Director, Federal Programs

TESTIMONY

on behalf of

THE NATIONAL SCHOOL BOARDS ASSOCIATION

on

TAX REFORM

before the

COMMITTEE ON FINANCE
U. S. Senate
215 Senate Dirksen Office Building

July 25, 1985

Presented by
Jonathan T. Howe
Second Vice President, NSBA

Also present for NSBA:

Thomas A. Shannon
Executive Director

Michael A. Resnick
Associate Executive Director

Katharine L. Herber
Legislative Counsel

NATIONAL SCHOOL BOARDS ASSOCIATION
1680 Duke Street, Alexandria, Virginia 22314 / (703) 838-6722
serving American education through school board leadership

INTRODUCTION

I am Jonathan T. Howe, Second Vice-President of the National School Boards Association (NSBA). I am pleased that we can submit this testimony to the Senate Committee on Finance. The National School Boards Association is the only major education organization representing school board members who govern the nation's public school districts. Throughout the nation, approximately 95,000 of these individuals are Association members. These people, in turn, are responsible for the education of more than 95 percent of the nation's public school children.

Currently marking its forty-sixth year of service, NSBA is a federation of state school board associations, with direct local school board affiliates, constituted to strengthen local lay control of education and to work for the improvement of education. Most of these school board members are elected public officials. Accordingly, they are politically accountable to their constituents for both education policy and fiscal management. As lay unsalaried individuals, school board members are in the rather unique position of being able to judge legislative programs purely from the standpoint of public education. without consideration to their personal professional interest.

I. REPEAL OF THE DEDUCTION FOR STATE AND LOCAL TAXES IS UNRELATED TO TAX SIMPLIFICATION

It is ironic that a proposal which advertizes itself as a "simple tax plan" would focus primarily on a repeal of the deduction of state and local taxes as the major means of achieving its' purpose. This is so for two reasons. First, the deductibility of state and local taxes is at once simple and incapable of engendering transactions which are without viability. Secondly, repeal of the deduction would signal a radical departure from the Federal balance struck between the 16th Amendment making Federal taxation of personal income Constitutionally permissible and the deduction allowed for state and local taxes, the collection of which is a traditional function of state and local governments.

This is not to say that because something is and has always been that it must always be. However, it behooves Congress to recognize the dramatic impact which repeal of this deduction will have on States and local units of governments, particularly school districts and, to be cognizant of the fact that the demise of this deduction will herald a significant shift in the attitude of the Federal government toward States, local communities and the citizens of this Country.

To advance this proposal under the guise of tax simplification is a strange use of the tax system. In truth, a cynic might say that the overall objective is to move government back to the localities. However, there is an inexplicable irony in that notion. While economic analysts differ in their assessment of the impact which repeal of this deduction will have when offset by lower tax rates, it is increasingly clear that lowering tax rates will not compensate for the overall loss to States and local units of government.

The single most publicized concern of the public in the area of tax reform has been generated by synthetic deductions and credits which are unavailable to the average taxpayer. Nonetheless, manipulation of the Tax Code by utilitzation of these legally permissible credits and deductions has resulted in a disparity between those who can afford to invest their monies to avoid taxation and, those who have no option but to pay taxes or go to jail.

Thus, while there is some rationale for the repeal of certain tax credits and deductions, the purpose for singling out the deduction for state and local taxes for repeal is clearly for a reason other than that which the public has been led to believe.

II. RAMIFICATIONS OF REPEAL OF THE DEDUCTIBILITY OF STATE AND LOCAL TAXES

The deduction for State and local taxes is unique. Unlike every other deduction or tax credit presently allowed under the tax code, this deduction is not the result of free choice. It does not represent a direct tangible monetary or personal benefit to the individual and yet, it is the only payment -- other than Federal taxes -- which consistently benefits the nation, the States and local units of government.

Those who have argued successfully for retention of the charitable contribution have articulated their position on behalf of those who feel they can afford to be generous. However, does not the deduction for State and local taxes represent a contribution from each wage earner in this country for services which inure to the benefit of the nation and which, absent the deduction, many could ill afford to pay?

Only 28% of the adults in this country have children attending public schools. Each of this nation's 16,000 school districts rely on State taxes and local property taxes for operation. This Committee must not be remiss in noting that repeal of this deduction, coupled with a request by the school district to increase taxes to meet school district obligations becomes, in effect, a charitable contribution absent a corresponding deduction for the 72% of the adult taxpayers who have no children in public schools.

In my own State of Illinois, the average itemized return deducts $720 for state and local taxes. To ask an Illinois taxpayer to "donate" even 10% more of that amount for public education would increase his net loss to approximately $800. NSBA submits to you that a taxpayer with no children may find it more attractive to vote against such a tax increase and "donate" where he will realize, at the least, a deduction for his investment.

III. CONCLUSION

NSBA is gravely concerned that a repeal of the deduction for State and local taxes, when coupled with the proposal to severely restrict the traditional State and local use of tax-exempt bond issuance and its attendant financial benefits to provide public services is unresponsive to the public's demand for tax simplification and reform. Rather, NSBA believes that the proposal to eliminate the deduction of State and local taxes and to curtail the local use of tax-exempt bond issuance deals a blow to the purpose of government taxation from which States, communities and school districts will be unable to recover.

Therefore, NSBA is conducting a survey of its members in order to offer you more than a hypothesis of the final result of the tax simplification proposal. The survey will indicate clearly and unambiguously whether the brunt of this proposal will fall on those who will continue to enjoy the fruits of synthetic tax credits and deductions or, on those who can afford no more than that which may be acquired by their tax dollars.

The results of that survey will be available to this Committee no later than September 15, 1985. Therefore, NSBA urges this Committee to withhold final judgment on any tax simplification proposal which would repeal the deduction for state and local taxes and curtail tax-exempt bond issuance to States and locales until you have had an opportunity to assess the impact these proposals will have on local units of government and the people you represent.

PREFACE

The National School Boards Association is pleased to submit this extension of testimony for the record to the the Senate Committee on Finance. The National School Boards Association is the only major education organization representing school board members who govern the nation's public school districts. Through the nation, approximately 95,000 of these individuals are Association members. These people, in turn, are responsible for the education of more than 95 percent of the nation's public school children.

Currently marking its forty-sixth year of service, NSBA is a federation of state school board associations, with direct local school board affiliates, constituted to strengthen local lay control of education and to work for the improvement of education. Most of these school board members are elected public officials. Accordingly, they are politically accountable to their constituents for both education policy and fiscal management. As lay unsalaried individuals, school board members are in the rather unique position of being able to judge legislative programs purely from the standpoint of public education, without consideration of their personal professional interest.

I believe that provincial institutions are useful to all nations but nowhere do they appear to me to be more indispensable than amongst a democratic people. . . I have heard citizens attribute the power and prosperity of their country to a multitude of reasons, but they all placed the advantages of local institutions in the foremost rank. Am I to suppose that when men who are naturally so divided on religious opinions and on political theories agree on one point (and that one of which they have daily experience), they are all in error? The only nations which deny the utility of provincial liberties are those which have fewest of them; in other words, those who are unaquainted with the institutions are the only persons who pass a censure upon it.

Alexis de Tocqueville
Democracy In America

It is a misfortune, inseparable from human affairs, that public measures are rarely investigated with that spirit of moderation which is essential to a just estimate of their real tendency to advance or obstruct the public good; and that this spirit is more apt to be diminished than promoted, by those occasions which require an unusual exercise of it.

James Madison
The Federalist
No. XXXVII

INTRODUCTION

The purpose of this Testimony is to address issues raised by the proposed repeal of the deduction for State and local taxes.

Substantively, the issues concern themselves with how local and State governments have traditionally raised revenues to carry out the functions of local government and, how those functions would be curtailed if this deduction is repealed.

However, there is a broader issue raised by the proposed repeal of this deduction. That is, does repeal of the deduction for State and local taxes serve the best interests of the purpose of the government of the United States?

NSBA believes that repeal of this deduction would suppress local government in two ways. First, it would negatively impact the ability of State and local governments to raise the revenues necessary to carry out their governmental functions. Secondly, it has the potential of creating a serious friction between the State and its cities, as well as between various arms of State and local governments as each competes for the dwindling tax dollar.

Futhermore, NSBA believes that repeal of this deduction would not serve the purpose of the United States government and, therefore, could not serve the interests of the citizens of this country.

The basis for NSBA's position is setforth herein below.*

I. THE PURPOSE OF THE FEDERAL GOVERNMENT IS THE PUBLIC GOOD.

Because Americans treasure representative democracy, democracy is often perceived as the purpose of government. However, the word "democracy" is descriptive in nature and, denotes the form of American government.

Rather, the purpose of the American democratic system is found in the oft utilized synonym for the "United States" -- the Republic.

The word Republic is a proud word. It has its origin in the Latin words Res - Publica, literally translated as the "public thing" or "public good". Thus, the Republic of the United States is ". . . no other than Government established and conducted for the interest of the public, as well individually as collectively".1/

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*NSBA addressed the substantive issues in its written and oral testimony before the Senate Finance Committee, July 25, 1985, and incorporates herein that testimony by reference.

1/Paine, Thomas; Rights of Man; p. 174.

II. THE FEDERAL AND STATE/LOCAL GOVERNMENT SERVE SEPARATE BUT EQUAL FUNCTIONS FOR THE PURPOSE OF THE REPUBLIC.

Prior to establishment of the United States there were autonomous Republican States. Their purpose in joining together to form a single nation was not the casting aside of their autonomy. Their purpose was the ". . . creation of a more perfect Union . . ." which could accomplish for all that which was difficult or impossible for one State, acting alone, to do.

The Constitution sets forth in detail the functions of the Federation of States as well as explicitly reserving to the States all manner of functions which were unrelated to international or inter-State concerns.

Thus, the Federal government was charged by the Constitution with certain tasks, e.g. making foreign policy, regulating commerce between the States and defending all the States from foreign attack. Moreover, the States continued to be responsible for all functions of government which were not delegated to the Federal government: education of its people, the building of roads, keeping the peace, and the plethora of governmental responsibilities which promote the political, social and esoteric needs of local communities.

III. THE ABILITY TO FULFILL THE REQUIREMENTS OF GOVERNANCE IS DEPENDENT ON RAISING REVENUES

> Money is, with propriety, considered as the vital principle of the body politic; as that which sustains its life and motion, and enables it to perform its most essential functions.[2]

No man argued more strenuously for the imposition of a direct, Federal tax on the people of the United States than did Alexander Hamilton. Hamilton recognized that the power to govern was inextricably tied to the ability to raise revenues providing for the pecuniary wants of the citizens. The absence of Federal freedom to collect those revenues directly from the people was a constant source of fear to Hamilton who warned that the result would be one of two evils: ". . . either the people must be subjected to continual plunder . . . or the government must sink to atrophy, and, in a short cause of time, perish."

Hamilton's arguments bore no fruit during his lifetime. The opposition to direct Federal taxation of the people was too strong.

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[2] Hamilton, Alexander; The Federalist No. XXX, p. 175.

The basis for the opposition was twofold: a fear of a too-powerful central government which would encroach upon the autonomy of the States and, the fact that it would result in double taxation by virtue of the fact that the Federal government would be exacting a tax on property (real and/or personal) which was already subject to State taxation.

It was not until 1909, more than 125 years after the United States came into being that the States ratified the 16th Amendment providing for a direct Federal taxation of its citizens.

IV. THE HISTORY OF THE DEDUCTION FOR STATE AND LOCAL TAXES

A deduction for payment of any and all taxes paid by individuals was allowed in the Civil War tax on incomes. (Act of August 5, 1861, Pub. L. No. 40, 49, Ch. 45, 12 Stat. 292). Unfortunately, the deduction was added in Conference. Thus, there is no published Congressional discussion on the reasoning for allowing the deduction.

The Tax Code which was adopted in response to the 16th Amendment contained a deduction for ". . . all nations, State, county, school and municipal taxes paid within the year . . ." but, excluded those assessed against local benefits. (38 Stat. 167). However, once again, the deduction was non-controversial and not the subject of discussion or debate.

The scope of the deduction for state and local taxes has been narrowed twice in the 72-year history of the Tax Code.

A. 1964

In 1964, Congress eliminated deductions for taxes on tobacco, alcohol, selective sales, auto and drivers' license fees, and certain local improvement taxes. (Pub. L. No. 88-272, §207(a), 78 Stat. 40-42). It is instructive to note that the House Ways and Means Committee Report found that retention of the deduction for State and local income taxes was necessary to balance the heavy burden which would be placed on those who were taxed on their income on the Federal, State and local levels. Furthermore, the Report goes on to note that a repeal of the deduction of local property taxes was unthinkable as it would result in a material shift in the apportionment of the Federal tax burden between homeowners and non-homeowners. Finally, the Report argued that it was incumbent upon the Federal government to provide tax neutrality in the choice of State and local taxes through retention of the deduction for sales tax.

B. 1978

In 1978, Congress repealed the deduction for State and local gasoline and motor fuel taxes. (Pub. L. No. 95-600, §111, 92 State. 2777). The House Committee on Ways and Means

Report directs itself solely at the narrow issue of the repeal of taxes imposed on motor fuel and gasoline and does not speak to the broader issues raised by other components of the State and local tax deduction. (H. Rep. 95-1445, 95th Cong. 2nd Sess., 41-42 (1978).

It is unfortunate that there is no extant, detailed discussion articulating the basis for a deduction for the payment of State and local taxes. However, the absence of such discussion is at once beneficial and instructive for it is an indicia that the Congress has traditionally realized the necessity of Federal tax neutrality in the choice between State and local taxes as well as the adverse impact double and/or triple income taxation would have on citizen taxpayers.

V. REPEAL OF THE DEDUCTION FOR STATE AND LOCAL TAXES IS UNRELATED AND UNRESPONSIVE TO THE PUBLIC DEMAND FOR TAX REFORM

It has been suggested that repeal of the deduction for payment of State and local taxes is in response to the public demand for tax reform. The publicized public demand for tax reform is based on two complaints: the Tax Code is too complicated and, the tax system generates inequities which result in those who are perceived as best able to pay, contributing little or nothing in tax payments.

A. Repeal of This Deduction Will Not Simplify the Tax Code.

The deduction for the payment of State and local taxes is based on actual payment made. The deduction requires no complex mathematical computation and engenders no secondary credits or deductions.

Thus, repeal of this deduction would not decrease the complexity of the Tax Code in any real way.

B. Repeal of This Deduction is Unresponsive to the Public's Demand for Tax Reform.

The public demand for tax reform is occasioned by inequities in the Tax Code which generate synthetic deduction and tax credits resulting in many individuals and corporations paying little or no taxes.

The State and local tax deduction is available only to those individual's who pay State and local taxes. Therefore, repeal of this deduction does nothing to eliminate inequities in the Tax Code which result in corporations and individuals paying little or no tax.

Therefore, repeal of this deduction is unrelated and unresponsive to the public's demand for tax reform.

IT IS NOT IN THE BEST INTEREST OF THE UNITED STATES TO REPEAL THE DEDUCTION FOR PAYMENTS TO U.S. LOCAL AND STATE GOVERNMENTS AND TO RETAIN THE TAX CREDIT FOR THE PAYMENT OF FOREIGN TAXES BY U.S. CITIZENS LIVING ABROAD.

A tax deduction is a debit against a taxpayer's income. It reduces the amount of money on which the income tax is assessed. Alternatively, a tax credit is a debit against a taxpayer's final tax assessment.

A U.S. taxpayer residing in the U.S. is allowed a deduction for the payment of State and local taxes. However, a U.S. citizen residing in a foreign country which taxes the U.S. citizen's income is allowed a tax credit for taxes paid to the foreign country in which they reside.

Thus, under current law, U.S. citizens residing abroad are able to make a tax contribution to a foreign country and take full advantage of their payment in support of a foreign power. Alternatively, a U.S. citizen residing in a State who contributes taxes to their State and local governments is allowed only a deduction for their payment in support of a community which represents the backbone of the United States.

It is therefore, ironic that the Tax Proposal should choose to repeal a deduction for the payment of taxes in support of the United States in the name of "tax reform" and, simultaneously retain the tax credit for the payment of taxes in support of a foreign power.

There is no logic which can conclude that it is in the best interest of the purpose of the United States government to repeal the deduction for payments which inure to the benefit of the people of this country while, at once, retaining a credit for payments which inure only to the benefit of the individual who takes advantage of the credit and the foreign country in which they reside.

It cannot be said that the Congress has not the Constitutional power to repeal the deduction for State and local taxes. However, Congress must address the question of whether it is in the best interests of the purpose of the United States government to exercise the power of repeal and thereby take the first step toward eroding the freedom of State and local governments to collect revenues for the purpose of fulfilling their purpose.

The objective observations of de Toqueville are no less true today than they were in the 1700's:

> I believe that provincial institutions are useful to all nations, but nowhere do they appear to me to be more indispensable than amongst a democratic

> people. . . . How can a populace, unaccustomed to freedom in small concerns, learn to use it temperately in great affairs? What resistance can be offered to tyranny in a country where every private individual is impotent, and where the citizens are united by no common tie? Those who dread the license of the mob, and those who fear the rule of absolute power, ought alike to desire the progressive growth of provincial liberties.[3]

While there is some argument in favor of the repeal for this deduction, it is surely an argument of last resort. There is no other deduction or tax credit allowed by the Tax Code which directly fosters the growth of provincial or national liberties. Rather, every other deduction and tax credit promotes the individual's weath and/or corporate wealth and accumulation of property.

Congress must therefore, ask itself whether the deduction for State and local taxes should not be the last deduction repealed by the Federal Government, rather than one of the first.

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[3] de Tocqueville, Alexis, Democracy in America, p. 94.

Senator **Durenberger**. Senator Moynihan.

Senator **Moynihan**. Mr. Chairman, I want to say something of some urgency. We've had a special set of witnesses today. Without exception, they have one distinction. They have one thing which differentiates them from so many of the people who've come before us. They have been elected to office by citizens of this country. And it is extraordinary. Think about it. We first heard from Governors representing the 50 States. Then we heard from Senator Marchi, chairman of the finance committee of the New York State Senate—a body older than this one by a few years—representing 100 State legislatures; and Mayor Voinovich, representing the 15,000 cities in the League of Cities. And we have heard from the representatives of 3,800 counties as well.

And with the exception of one gentleman from Pennsylvania, you have been unanimous in your testimony. [Laughter.] We have not seen in my time on this committee, 8½ years now, such a display of the spirit of federalism. There are other governments in this system. Not just this one here. And it's not an administrative arrangement. It's not put together because the Yankees were different from the Virginians and the Quakers in between. It's a series of governments—not just about limiting power, but of sharing power.

And look at them down there. Consider, for example, the least understood of all of our units of government, the school board—the most public regarding, the quietest.

Yesterday, on the way out we were talking about this and the chairman said, "You know, I suppose really the unsung heros of American public life are those elected members of school boards who have listed telephones." [Laughter.]

All right. You don't run as a Democrat or Republican or anything. You have your elections. We do it in the spring. Do you?

Mr. **Howe**. Spring or fall.

Senator **Moynihan**. Yes. Keep it away from regular party politics. But you keep that public school system going. And here they are unanimous. I think the Senate must hear this and it will.

I have one question, if I can, and just answer in the order you spoke.

If it were to be established by the Congressional Budget Office, the Joint Tax Committee and other economic advisers that the President's proposal would increase the Federal deficit, would you be for it?

Mayor **Morial**. Senator Moynihan, I cannot speak for the Conference of Mayors since we have taken no policy position on that.

Senator **Moynihan**. But individually, of course.

Mayor **Morial**. But individually I would say that it would be unacceptable, if it were to impact unfavorably upon the deficits.

Mayor **Voinovich**. It's unacceptable to us because it is revenue neutral, as I stated in my testimony. Tax reform should be tied in with doing something about the deficit, and the money that we get from it should be applied to reducing that deficit.

Senator **Moynihan**. And the package we have is going to increase it.

Senator.

Mr. **Marchi**. Again, I would like to go back. Revenue neutrality is effective the day that the act becomes effective and then the dynamics begin to build up. You've got 15 percenters out there, 25 percenters and 35 percenters. And that's what all Americans are going to be known as—15, 25, and 35. One objective—the States are not going to be able to do it. My colleagues in the counties and these cities and the school boards aren't going to be able to do it. Mr. Pearlman said that Congress may. You are going to have lines that stretch out over half the United States. There are 13 million people delivering services at the local level and we are not going to be able to give them adequate answers or responses. But the political system is going to do it. And it's going to have three easy targets—bang, bang, bang. That 35 becomes 70 or 80. I don't know where we are ending. But, George Orwell, you are a little late, but you may be arriving. I hope not.

Senator **Moynihan**. Ms. Klinger.

Ms. **Klinger**. Revenue neutrality really depends on what all is on the table. I would like to comment that lowering the rates will result in a 30-percent decrease in deductibility of State and local taxes. And I think that's a very serious point.

Senator **Moynihan**. Dr. Howe.

Mr. **Howe**. Again, you have to look at the totality of what is going to be done. And I think it would be inexcusable for any public official to do anything to continue to increase the deficit levels at the rates that we have seen. And I think that we would have to look at the totality of what Congress proposed relative to a restructuring of the Tax Program. But more important, I believe, would be the reduction of the deficit.

Senator **Moynihan**. Well, I think that's going to be our next question, as the Joint Tax Committee reports this week or next.

We thank you very much. We are honored by your company, and this committee will not long forget this day.

Senator **Durenberger**. Let me ask you a couple of questions. I know usually these hearings are held when there is a Federal proposal before us, and most of these organizations come in saying they are against the proposal.

I'd like to ask if any of the associations are for a couple of things, and at least favors any federal policy.

Does any of your associations have a position it has taken on a Federal policy? Specifically, a Federal policy with regard to housing. Not what it shouldn't be, but what it should be.

I agree with several of you who brought this issue up. And I think it was Ms. Klinger who said it is the most important issue facing local government officials. Which association represented here has an adopted policy or position on what Federal policy ought to be in housing?

Mayor **Morial**. Senator, we have taken some policy positions at the U.S. Conference of Mayors. Our position is that there is a direct role that the Federal Government should play in promoting and influencing housing within this Nation to the extent that there might be subsidies, special tax credits, and tax considerations relative to meeting the needs of housing in this Nation. And it is a critical problem that's so massive that even the Department of Housing and Urban Development, in this country has not been able to meet the demand or the needs for housing within this country. I think Mayor Voinovich indicated that in his remarks. And I will not attempt to speak for him, but I think he made it clear as to what the position is of local governments relative to housing within this country.

Senator **DURENBERGER**. Senator?

Mr. **MARCHI**. Just that there is no stated position of the conference. But, of course, that problem has been very much on the front burner in the State of New York for a very long time, for decades.

Senator **DURENBERGER**. The conference does not have a position? That's what I want to know.

Mr. **MARCHI**. No, no; they do not. But I will say this: That we are not alien to the process. Indeed, the State of New York on the question of affordable housing has had to have a positive policy even before Federal Government or anybody else became involved. And I would say, to echo the distinguished mayor, that this still is a matter which we would join and certainly want to participate actively. Going back even to Senator Taft who had a very strong policy on housing, if we just wanted to be historical.

Senator **DURENBERGER**. George.

Mayor **VOINOVICH**. We have had a policy for a long time, and fundamentally it is that every American is entitled to decent, safe housing. Every provision that provides for housing should be on the table, to the wealthy, middle class, or poor, and priority should be given to those that are in the most need in terms of housing. So if we put all of it on the table, as I mentioned in my testimony, we would say, No. 1, programs dealing with low and moderate income housing probably should be given the highest priority.

Senator **DURENBERGER**. OK. Ms. Klinger.

Ms. **KLINGER**. As a part of county platform, our general statement is that county governments have a moral obligation and should assume the responsibility to help provide decent housing for all segments of the population. One of the reasons we believe the tax-exempt nature of municipal bonds should be safeguarded is these bond proceeds are badly needed and should be used in a manner that will help provide affordable mutlifamily housing in this country.

Senator **DURENBERGER**. Thank you.

Mr. Howe.

Mr. **HOWE**. Happily, housing is one of the very few issues you haven't asked school boards to tackle. [Laughter.]

Senator **DURENBERGER**. Well, I can understand why. If you are moving off dependence on the property tax, maybe that's not an issue for school boards; but it sure as heck ought to be.

I just want to say that it strikes me—and George laid out the various approaches or somebody else did. This committee sets most of the national housing policy without knowing that it's doing it. And we have done it over the years with the Tax Code. We've done it in a variety of ways. And we have run the cost of shelter in America up from $4,000 or $5,000 a year, when I became an adult, to $86,000 or $90,000. My kids now are at the point where they would like to buy a house but can't afford one. And that's some mish-mash in policies. And, with all due respect, it does not get solved by an association whose position is: Every American is entitled to decent, safe housing. I don't say that critically. I say that by way of an appeal to the associations that have the problems, the elected officials that have the responsibility of sheltering the homeless. I just want to say that for 7½ years I haven't detected on my part, our part, your part, anybody's part a willingness to come to grips with the fact that this Nation does not know where the hell it is going in terms of sheltering people. And I agree with all of you that it's a terrifically important problem.

And I would just encourage all of you to put it somewhere on your priorities, including the School Boards Association, because education is sure as heck in competition with a lot of other local services for those dollars.

Mayor **Voinovich**. Senator, we have been very strong in support of housing matters before this body for many years. Multifamily housing.

Senator **Durenberger**. And all of that has gotten us $90,000 housing. That's the problem, George. And we can't afford $90,000 housing. And all of us jointly have to try to figure out what is our best role. Is it that? Is it this? Is it in the Tax Code. Ron Pearlman would say forget the Tax Code. You and I would say it is probably properly an organized tax decision mechanism which is some form of consumer choice of what you want, and is probably a lot better than some of the alternatives that we have experienced.

But I don't know that we here are capable of addressing that issue without the help of the associations that are here.

Mr. **Howe**. Senator, I might say from a school board point of view that, generally, our housing issues are not handled at the national level, but rather they are handled at the local level as to the type of housing, what is encouraged, the role of schools in providing adequate services to any changes in the demographics of a community. But from a national point of view we have felt properly, I believe, that the local issue of housing and the services that are to be provided through the schools are those which properly belong and should be decided at the local level.

Mayor **Voinovich**. Senator, may I make one other point?

Senator **Durenberger**. OK, George.

Mayor **Voinovich**. We have some distinguished research in this area. Cushing Dolbeare put together a book—and Senator Moynihan, you got it when you were at our last meeting. We will provide you with a copy—it is called "Who Gets It and Who Needs It." It's very, very illuminating. It lays it out as to who is really getting the subsidy in housing in the United States of America. And we think that you could start with that and decide who gets it and how much it costs. And it sets some priorities. But you have got to do that, as you well know, within the area of the deficit. That's the other side of it. And may even require to maintain a housing program.

[A policy working paper of the National League of Cities follows:]

FEDERAL HOUSING ASSISTANCE: WHO NEEDS IT? WHO GETS IT?

by

Cushing N. Dolbeare
Consultant on Housing and Public Policy

A Policy Working Paper
of The National League of Cities

PREFACE

On behalf of NLC's Board of Directors and member cities, we are pleased to present this excellent study of housing policy by Ms. Cushing Dolbeare.

The need for this report arose from policy discussions among the elected officials from NLC's member cities during 1984. Those discussions resulted in the adoption of a policy statement that was added to NLC's National Municipal Policy in November at our Annual Congress of Cities. Those policy positions are outlined in "A Note About NLC Housing Policy" by William Barnes.

The analyses in Dolbeare's report provide background for these NLC policies. We hope that this report will be useful to others in developing a broader view of federal housing policy and that the report will generate discussion and further investigation.

We invite comment on the policies that NLC has adopted and on the analyses presented in Dolbeare's paper. We look forward to working with all those concerned with housing policy on the important questions that are raised here.

Alan Beals
Executive Director
National League of Cities

William E. Davis, III
Director, Office of Policy
Analysis and Development

A Note About NLC Housing Policy

by

William R. Barnes
Senior Policy Analyst
National League of Cities

At NLC's Congress of Cities in Indianapolis, in November 1984, the membership of the National League of Cities added a new segment to its policy statement regarding housing. This additional policy statement, reproduced below, focuses on the housing policy dimensions of the federal tax code:

> Housing and the Tax Code
>
> Priority in federal housing assistance -- whether provided directly or through provisions in the tax code -- should be given to meeting the housing needs of people who could not otherwise obtain decent, affordable housing. The balance between monies devoted to low-income housing assistance and the homeownership provisions of the tax code should be reviewed.
>
> All federal housing assistance, including that which results from provisions in the tax code, should be considered in a housing policy context. As a step in that direction, we recommend that the President include in his budget request and the Congress include in its first budget resolution, an analysis of the distribution of all housing assistance among income classes.
>
> Revenues realized from changes in housing-related tax provisions and from housing expenditure programs should be used for production, rehabilitation, and housing allowances for low-income households.
>
> Until effective alternative housing supply and financing mechanisms are put in place, the present tax incentives for the production, rehabilitation, and maintenance of low-income housing should be retained.

To explain the analytic background for this policy and to stimulate discussion on what NLC regards as very important issues, we asked Ms. Cushing Dolbeare (Consultant on Housing and Public Policy) to provide the background paper which is presented here.

Adoption of the new policy statement in November culminated a year of discussions in NLC's Community and Economic Development Policy and Steering Committees. Those discussions dealt, on the one hand, with the need for low income housing assistance in cities and the status of federal housing programs. On the other hand, the discussions dealt with the treatment of housing in the federal tax code. When these two discussions merged, certain issues came clearly into focus and the new policy statement was the result.

This NLC policy contains two general principles. The first is that "priority in federal housing assistance, whether provided directly or through provisions in the tax code, should be given to meeting the housing needs of people who could not otherwise obtain decent housing". In other words, federal housing assistance should be targeted to need, regardless of the source or delivery mechanism. The second general principle is that "all federal housing assistance, including that which results from provisions in the tax code, should be considered in a housing policy context." Housing policy is housing policy whether it is manifested through direct expenditure programs, through the tax code or -- although the statement does not specifically mention it -- through credit activities of the federal government.

When these two general principles are brought together and applied as criteria to the existing patterns of federal housing assistance, some striking incongruities appear. These are detailed in Part 4 of Dolbeare's paper, and might be summarized in two statements: (1) the richer you are, the more likely you are to receive federal housing assistance and the more you are likely to get, and (2) the big money for federal housing assistance is delivered, not through the direct expenditure programs like public housing or Section 8, but through the tax code. It is based on the fact of these incongruities that NLC's statement goes on to say that "the balance between monies devoted to low income housing assistancee and the homeownership provisions of the tax code should be reviewed". Dolbeare's paper provides an analysis of the existing "balance".

The NLC statement goes on to suggest that the President should include in his budget request and the Congress should include in its first budget resolution an analysis of the distribution of all housing assistance among income classes. While it is true that this information is available in certain HUD documents, NLC's members concluded that putting such an analysis in more publicly salient documents -- documents whose owners are the elected officials of the federal government -- would focus more attention on it and help stimulate the discussions which are needed to move us toward the substantive recommendations made in the statement. This would be a step in the direction of a more systematic and inclusive federal housing policy.

Other steps need to be taken in this direction. The Department of the Treasury (with jurisdiction over the tax code) and the Department of Housing and Urban Development (ostensibly the housing policy focus in the federal government) should find some way to bring their separate elements of housing policy together. Similarly, on Capitol Hill, the tax committees and the housing committees in the Congress need to find some ways to bring together the housing policy elements that are now held quite separate and distinct.

These views were recently elaborated in testimony by Councilmember Ruth Scott of Rochester, New York on behalf of NLC before the Subcommittee on Housing and Community Development of the Committee on Banking, Finance and Urban Affairs in the House of Representatives. Ms. Scott, who is a member of NLC's Board of Directors, said refering to the policy statement quoted above:

> The policy statement adopted by NLC demonstrates that city leaders, in increasing numbers, are realizing that the federal Treasury and Internal Revenue Service have come to dominate federal urban policy, virtually preempting other federal cabinet agencies. Similarly, in the Congress, the Senate Finance and House Ways and Means Committees have inadvertently become the preeminent urban policy makers in the fields of housing, economic development, transportation, energy, employment, health, income security, infrastructure, and municipal fiscal stability.
>
> In the past few years, the enormous federal deficit stretching out seemingly forever has led the Administration and Congress to reduce or freeze virtually all assistance programs to cities.
>
> . . . every direct assistance program to cities is under intense scrutiny and must overcome at least four obstacles (President's budget, first Congressional budget resolution, authorization action, and appropriations).
>
> With these reductions in both nominal and real dollars, there is less and less of a policy making role for cabinet agencies and Congressional authorizing committees.
>
> In contrast, provisions in the Internal Revenue Code which provide incentives for certain kinds of investment undergo little scrutiny. They are immune to policy considerations from the appropriate federal agencies and Congressional committees. They are immune to the Congressional budget process.
>
> Except in rare instances, tax incentives, or federal tax expenditures become indexed entitlement programs. That is, once a provision creating a

> certain kind of tax incentive is inserted in the code -- such as, for instance, the mortgage interest deduction -- the value of the revenue loss to the federal treasury is not subject to any policy review by HUD or the House or Senate Housing Subcommittees. The value is not subject to the concurrent budget resolutions. The value is not subject to the Congressional appropriations process. Moreover, because it is built into the tax system, it is a value which grows significantly faster than inflation . . . .
>
> City officials have assumed that federal urban policy is the job of HUD and the House and Senate Banking and Urban Policy Committees to set . . . . Yet, the opposite is increasingly the case.
>
> . . . . Consider an example. The U.S. Treasury has estimated that in 1984, federal housing tax expenditures for the mortgage interest deduction for vacation homes equalled $1.2 billion.
>
> Yet there is no evidence that anyone at HUD reviewed that expenditure and recommended that part of federal housing policy be to allocate $1.2 billion of assistance to Americans who could afford vacation homes. Similarly, no committee in Congress held hearings to determine if -- at a time when cities are faced with a growing problem of housing the homeless -- it was appropriate to provide these families, who can afford a second home, with this large a level of assistance -- a level, moreover, which has grown annually in every year without any review by any committee at the very time when the current Administration and Congress have said time and again that the federal government must take drastic action to reduce federal assistance for housing.
>
> As the role of direct assistance and policy making has declined, the role of tax policy and its impact on cities has become proportionately greater.

Scott's testimony also reflects another policy statement, adopted by NLC's members in November 1984, which treats the tax expenditure issue generally. It calls for joint referral of all tax expenditures to both authorizing and tax committees in the Congress. It also says that "each tax expenditure should annually be considered part of the total budgeted resources available in each program area" and that "each tax expenditure should have a sunset date" to encourage "careful oversight".

The NLC housing policy recommends a specific strategy that would begin to address the imbalance in the distribution of current federal housing assistance and to facilitate the interaction between the tax and direct expenditure aspects of federal housing policy. The statement recommends that "revenues realized from changes in housing-related tax provisions and from housing expenditure programs should be used for production, rehabilitation, and housing allowances for low income households".

One mechanism for achieving such shifts of funds from the tax side to the expenditure side would be a "trust fund". Let us say, for example, that Congress enacted a restriction on the mortgage interest deduction for vacation homes. Treasury estimates that this would save $1.2 billion per year. All or some significant portion of these savings (i.e., increased revenues) could be earmarked into a Low Income Housing Trust Fund. The guidelines for the use of these Trust Fund monies would be the responsibility of the respective Banking Committees in the House and the Senate. Funding of such a Trust Fund could also include the imposition of a small capital gains tax imposed upon sellers of houses at the time of sale. Moreover, studies by David Rosen of program ideas for several states suggest that funding might also come from earmarking revenues from various housing-related escrow accounts into such a Trust Fund.

Finally, the NLC statement adopts a tactical approach to the tax incentives now in place for the production, rehabilitation, and maintenance of low income housing. It says that "until effective alternative housing supply and financing mechanisms are put in place" the present tax incentives should be retained. This position is based on the view that the present tax incentives for low income housing may not be the most efficient way to deliver this assistance, but that they should be retained until such time as effective alternatives are securely in place with adequate funding.

Assuming that such replacements would be direct expenditure programs, this amounts to a recommendation for "buying out" the low income housing provisions of the tax code. The Trust Fund idea might be viewed similarly. For those who feel that the tax code should be a means of raising revenue, not be a vehicle for policy, such a "buying out" approach might be the way to build a long term consensus around eventual tax reform, on the one hand, and adequate policy, on the other hand.

The policy adopted by the National League of Cities in November 1984 is a permanent policy unless amended. It sets a direction for NLC's advocacy and also for further NLC policy development. Specific definition of NLC positions on the multitude of practical policy and program questions that this statement engenders will come -- as this statement did -- from NLC's standing policy process, which involves city officials from across the country in year-round discussions of important urban policy questions.

FEDERAL HOUSING ASSISTANCE: WHO NEEDS IT? WHO GETS IT?

A Policy Working Paper
for the National League of Cities

by

Cushing N. Dolbeare
Consultant on Housing and Public Policy

EXECUTIVE SUMMARY

Adequate, affordable housing is a basic human need. The major thesis of this paper is that all federal housing expenditures, whether made as direct payments or in the form of "tax expenditures" -- should be treated together as expressions of federal housing policy. When this is done, the balance of these subsidies in the light of the nation's housing needs must be addressed. The paper provides background information to begin the process.

Who Needs Housing Assistance? The vast majority of households living in inadequate housing or paying more than they can afford for shelter are poor. In 1981 there were 3.0 million seriously inadequate units and another 4.7 million units with significant deficiencies. By these measures, 9.3% of the housing stock is inadequate. An even larger number of households was paying more than they could afford for shelter. A total of 7.2 million owners and renters, 11.4% of all households for whom this data was reported, paid more than half of their incomes for shelter.

Roughly two thirds of all American households are home owners. Home ownership has been, and remains, a strong aspiration for many renters. As income rises, the proportion of owners increases. In 1980, 44% of the lowest income households were owners, compared with 93% of the highest income households. Median owner income was almost twice median renter income. However, there are almost as many owners as renters with incomes below $10,000, and substantially more owners than renters with incomes between $10,000 and $20,000.

Most low income renter households have very high rent-income ratios. In 1980, 62% of the 2.7 million renter households with incomes below $3,000 annually paid more than 60% of their incomes for rent, as did 30% of households with incomes between $3,000 and $7,000. Only a small proportion of low income renter households live in affordable units and the proportion of renters in affordable units rises with income.

Most low income renter households live in private rental housing, without federal subsidies. At 25% of income, a household with an income of $5,000 can afford only $104 monthly for rent, including utilities. There are twice as many households with incomes below $5,000 as there are affordable units in the housing inventory. Fewer than one fifth of the renter households eligible for and needing assistance are now living in federally subsidized housing.

Types and Distribution of Federal Housing Assistance. The major direct federal housing programs are provided either through the Department of Housing and Urban Development (HUD) or, in small cities and rural areas, through the Farmers Home Administration (FmHA) of the U.S. Department of Agriculture. The emphasis of federal low income programs has been on the provision of rental housing. As of the end of 1984, approximately four million households were receiving direct assistance through HUD's programs. In addition, almost three quarters of a million households in small towns and rural areas lived in housing subsidized, primarily with interest credits, by the Farmers Home Administration. By far the largest federal housing subsidies, however, both in cost to the Treasury and in number of recipients, are those provided through the tax code.

Since 1981, authorizations for additional federal low income housing assistance have declined sharply. They will go almost to zero if the Administration's 1986 budget proposals are adopted. Housing payment and operating subsidy outlays for occupied units have increased somewhat as additional units -- authorized earlier -- have been completed and occupied. Meanwhile the cost of housing-related provisions of the tax code has risen sharply.

In 1981, budget authority (as initially contained in the 1981 HUD appropriation, before cuts and rescissions) for low income housing was $30 billion, outlays for housing payments and operating subsidies for all units under HUD subsidy were $5.7 billion and the estimated cost of housing-related tax expenditures was $33.3 billion. The Administration's budget for 1986 calls for only $0.5 billion in budget authority for low income housing and $10.4 billion in outlays. Housing-related tax expenditures are estimated at $45.6 billion. Roughly 90% of the cost of the housing provisions of the tax code are accounted for by homeowner deductions of mortgage interest and property taxes and deferral or exclusion of capital gains on home sales.

The homeowner provisions in the tax code were not, with the exception of the capital gains provisions, inserted in order to provide assistance for home ownership. On the contrary, they are the result of a definition of income, which excluded interest and state and local tax payments, which was included in the tax code when it was first enacted in 1913, having been carried over from an emergency income tax enacted during the Civil War. Until the broadening of the tax base and the rise in home ownership following World War II, this definition had little impact.

Upper income people receive a disproportionate share of total federal housing expenditures. In 1981, one quarter of all households had incomes below $10,000, but they received only one-eighth of all federal housing assistance (direct and through the tax code). Lower middle income households -- 27% of all households -- received only 7% of all housing assistance. At the other end of the income distribution, one quarter of all federal housing assistance went to the 7% of all households with incomes above $50,000 and 43% of the assistance went to the 20% of households with incomes between $30,000 and $50,000.

The proportion of households receiving federal housing assistance, either directly or through tax expenditures, rises as income increases. Only about one eighth of taxpayers with incomes below $10,000 receive housing assistance, and about half of this assistance is direct (that is, federal housing assistance payments on behalf of these households to owners of subsidized units). About one fifth of all taxpayers with incomes between $10,000 and $20,000 receive housing assistance, primarily through the tax code. In contrast, two thirds of all taxpayers with incomes between $30,000 and $50,000 and more than four-fifths of those with incomes above $50,000 receive housing assistance through the tax code.

Moreover, the average amount of assistance per household rises with income. In 1981, the average amount of federal housing expenditures per household was $10.40 per household per month for households with incomes under $10,000, rising to $155.54 per household per month for households with incomes above $50,000.

There is a myth that low and middle income homeowners are the chief beneficiaries of homeowner deductions. The facts do not support this. Although about two thirds of all households are home owners, only 28% of the tax returns filed in 1981 claimed homeowner deductions. This was primarily because the majority of taxpayers do not itemize their deductions. Most low income owners own free and clear, so they do not have mortgage interest deductions to claim. For others, incomes and marginal tax rates are so low that it does not pay them to do so. Therefore, they do not benefit from the homeowner provisions.

The magnitude of the subsidy imbalance is such that a more equitable approach to federal housing assistance could provide a substantial portion of the funds needed to deal effectively with the critical housing needs of low income people.

The first step in dealing with the problem of the imbalance of federal housing subsidies is to define the appropriate objectives for federal housing policy and programs. Then, both tax and direct expenditures should support these objectives. Given the magnitude of housing needs, it should be axiomatic that federal housing assistance should be directed toward providing decent, affordable housing for those who cannot not obtain or retain it in any other way.

CHAPTER ONE

INTRODUCTION

Adequate, affordable housing is a basic human need. The housing sector also plays an important role in the economy. For these reasons, the federal government -- for more than half a century and in a variety of ways -- has been involved in the financing and production of housing and in assisting people to obtain decent housing at affordable costs.

Federal activities related to housing have been variously motivated and have had numerous effects. The public housing program, for example, was motivated in large part by the need to provide jobs during the depression of the 1930's. Since the end of World War II, a number of efforts have been made to stimulate the economy through federal housing stimulus programs. The development of federal mortgage insurance programs, also initiated during the depression, has changed the entire nature of financing home purchases and has assisted in a major expansion of home ownership. These insurance programs have been augmented by an array of federal credit programs directly or indirectly supporting the construction or purchase of housing. Finally, the Internal Revenue Code has had a major impact both on the nature of the housing market and the way in which housing is provided. Some of these tax provisions were inserted in the tax code in deliberate efforts to stimulate housing activities; the housing consequences of others, although major, appear to have been unintended.

Over the past few years, some of these federal housing activities have been subjected to careful scrutiny by both Congress and the executive branch as part of efforts to reduce federal spending. As a result, funding for the direct spending programs has been reduced greatly. But the housing-related tax expenditures have avoided such scrutiny and reduction.

The major thesis of this paper is that all federal housing expenditures should be treated together as expressions of federal housing policy. When this is done, the balance of these subsidies in the light of the nation's housing needs must be addressed.

This paper provides background information to begin the process of reviewing the patterns of federal housing expenditures. It describes briefly the nature of housing needs in the United States and contrasts this with the amount and distribution of federal housing assistance. The foci are direct spending and "tax subsidy" expenditures and low income housing needs, which are the most persistent and urgent of the nation's housing problems.

CHAPTER TWO

WHO NEEDS HOUSING ASSISTANCE?

There are a number of ways of assessing the need for housing assistance. For many years, housing quality was the dominant concern. In 1940, when the first housing census was taken, almost 40% of the occupied dwelling units in this country were either dilapidated or lacked basic plumbing facilities. While there is no strictly comparable measure available today, it is clear that the proportion has dropped to less than 5%. Even so, in 1980, some 2.2 million households lived in units that were either overcrowded or lacked some or all basic plumbing facilities.

More complete data on housing quality is now reported in the American (formerly Annual) Housing Survey as well as in the U.S. Census of Housing. Unfortunately, however, since many units contain more than one defect, it is impossible to estimate the number of seriously inadequate units from the published data. However, a special tabulation by HUD found that in 1981 there were 3.0 million seriously inadequate units and another 4.7 million units with significant deficiencies. By these measures, 9.3% of the housing stock is inadequate.

An even larger number of households was paying more than they could afford for shelter. A total of 7.2 million owners and renters, 11.4% of all households for whom this data was reported, paid more than half of their incomes for shelter. (This, and other data in this section is contained or derived from the 1980 Annual Housing Survey conducted by HUD and the Bureau of the Census.)

The vast majority of households living in inadequate housing or paying more than they can afford for shelter are poor. This paper focuses primarily on low income as a measure of the need for housing assistance both because the disparity between the cost of shelter and the income available for shelter is so great, and because it lies at the root of most other housing problems. For example, it is impossible to build or rehabilitate housing for low income people without substantial subsidies. And, because of construction and rehabilitation costs, these needs cannot be met through approaches based on income support alone. It should be noted, moreover, that there are other persistent housing problems which need continued exploration and attention even though they are outside the scope of this paper: the housing problems of special groups, such as elderly people or people with disabilities, farm workers, and large renter households; the supply, location and availability of housing; and housing discrimination.

Roughly two thirds of all American households are home owners, and home ownership has been, and remains, a strong aspiration for many renters. As income rises, the proportion of owners increases. In 1980, 44% of the lowest income households were owners, compared with 93% of the highest income households. Median owner income was almost twice median renter income. (See Table 1.)

Table 1

Income of U.S. Households by Tenure, 1980
(Households in thousands)

Income	Owners	Renters	% Owners
Under $3,000	2,155	2,748	44.0%
$3,000-$6,999	5,750	6,479	47.0%
$7,000-$9,999	4,367	3,862	53.1%
$10,000-14,999	7,217	5,553	56.5%
$15,000-$19,999	6,977	3,672	65.5%
$20,000-$24,999	6,707	2,263	74.8%
$25,000-$34,999	9,814	1,984	83.2%
$35,000-$49,999	6,002	699	89.6%
$50,000-74,999	2,445	207	92.2%
Over $75,000	1,082	88	92.5%
TOTAL	52,516	27,556	65.6%
Median	$19,800	$10,600	--

Source: Annual Housing Survey, 1980, Part C.

The large number of middle and upper income home owners has tended to mask the existence of a substantial number of low and moderate income owners. As Chart 1 shows, however, there are almost as many owners as renters with incomes below $10,000, and substantially more owners than renters with incomes between $10,000 and $20,000.

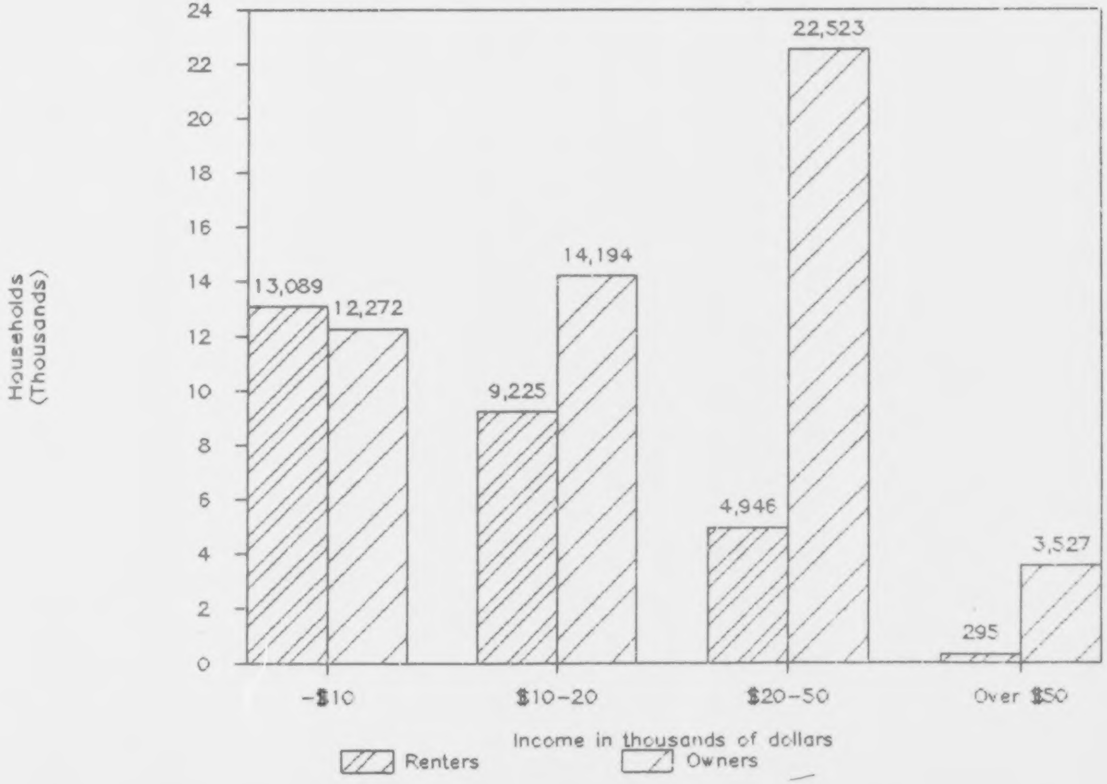
The correlation between income and housing need is less direct for owners than for renters. A substantial proportion of low income owners have paid off their mortgages. Not only do they have the equity in their homes, but their housing costs are primarily for utilities, insurance, repairs and taxes (which are also lower in many jurisdictions for low income owners).

Nevertheless, it is clear that many low income owners have significant housing needs. For example, in 1980, there were 2.2 million owner households paying more than 50% of their incomes for shelter. Almost 85 percent of these households had incomes below $10,000.

Unfortunately, however, the housing needs of low income owners remain a neglected area of both policy analysis and program support. In part because of lack of data and in part because the housing needs of low income renters are clearly more intense, the remainder of this analysis will focus on the housing problems of renters.

CHART 1

TENURE AND INCOME, 1980



Only a small proportion of low income renter households live in affordable units, while the proportion of renters in affordable units rises with income.

In 1980, 86% of renter households with incomes below $3,000 paid more than one quarter of their incomes for rent, as did 81% of households with incomes between $3,000 and $7,000, and 72% of households with incomes between $7,000 and $10,000. The situation for people at the bottom of the income scale was so critical that 62% of the 2.7 million renter households with incomes below $3,000 (10% of all renters) annually paid more than 60% of their incomes for rent, as did 30% of households with incomes between $3,000 and $7,000.

Fewer than one quarter of all renter households with incomes below $10,000 in 1980 paid less than 25% of their incomes for rent. About half of the households with incomes between $10,000 and $15,000 paid less than 25%, as did three-quarters of all households with incomes between $15,000 and $20,000. Chart 2 shows the 1980 figures for total renter households, by income group, and the number living in units at rent-income ratios of 25% or less.

On the other hand, more than nine tenths of all renter households with incomes above $25,000 were living in units which cost them less than 25% of their incomes. The contrast between households paying less than one quarter of their incomes for rent and those paying more than half is shown in Chart 3. (The figures are for gross rents, inclusive of utilities, and have been adjusted to include units on which no data was reported by the Annual Housing Survey.) Table 2 below provides additional details.

Table 2

Rent-Income Ratios, by Income, U.S., 1980
(Households in thousands)

Income (in thousands)

	-$3	$3-7	$7-10	$10-15	$15-25	$25+	Total
Number							
-25%	382	1,248	1,066	2,732	4,751	2,780	12,961
25-34%	279	981	1,213	1,836	909	135	5,353
35-49%	263	1,488	1,103	740	186	32	3,812
50-59%	130	816	261	111	25	7	1,351
60%+	1,694	1,946	218	133	64	24	4,078
TOTAL	2,748	6,479	3,862	5,553	5,935	2,978	27,556
Percent							
-25%	13.9	19.3	27.6	49.2	75.4	87.6	47.0
25-34%	10.2	15.1	31.4	33.1	18.8	9.6	19.4
35-49%	9.6	23.0	28.6	13.3	4.2	1.5	13.8
50-59%	4.7	12.6	6.8	2.0	0.4	0.4	4.9
60%+	61.6	30.0	5.6	2.4	1.2	0.9	14.8
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0

CHART 2

RENTERS IN AFFORDABLE UNITS, 1980

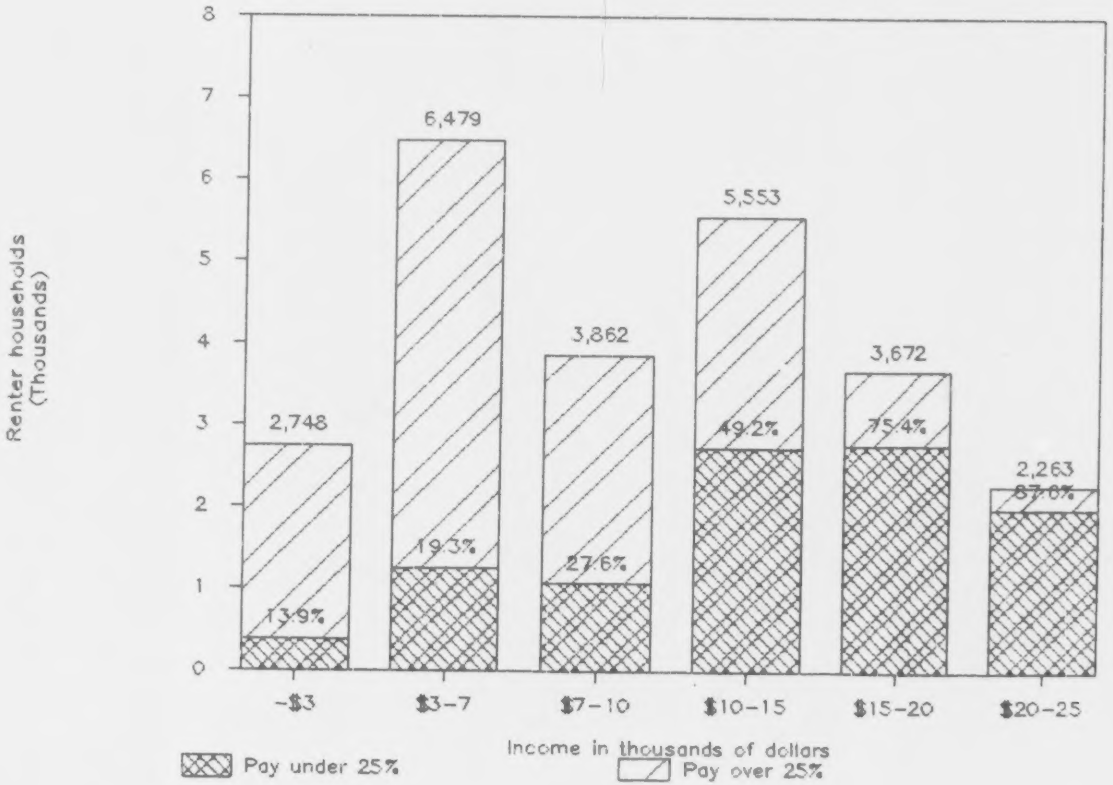
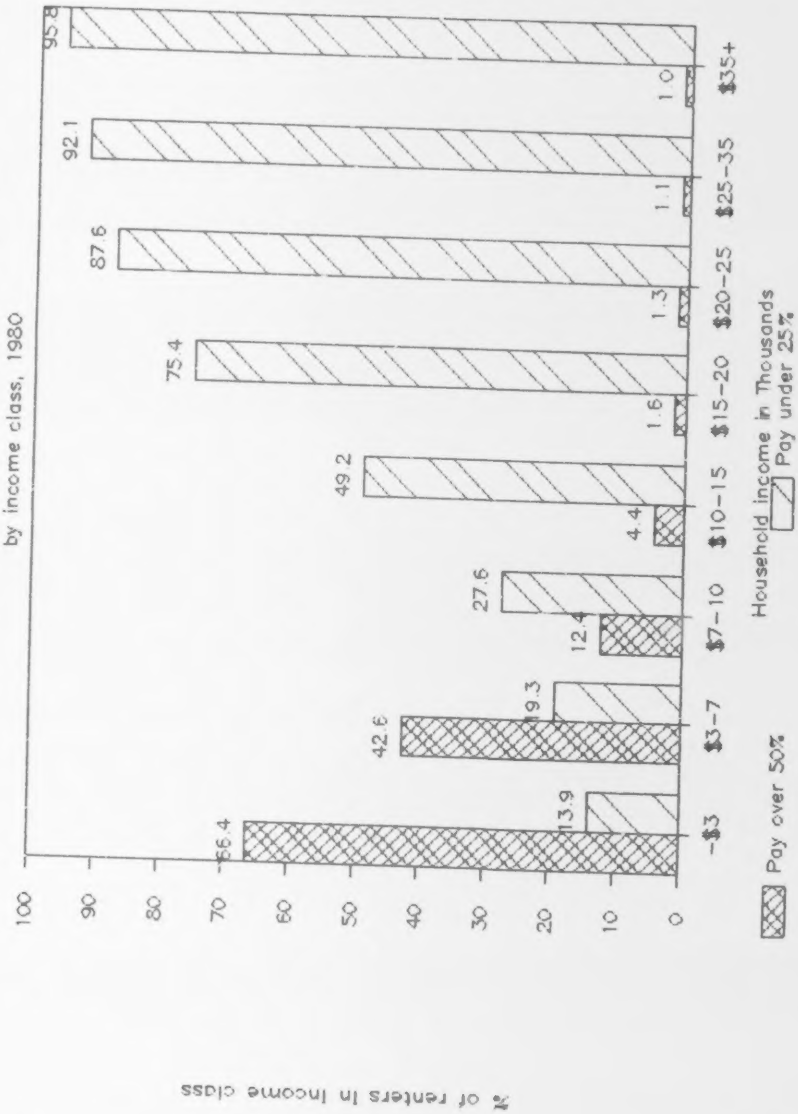


CHART 3

CONTRASTING RENT-INCOME RATIOS

by income class, 1980



The foregoing figures are based on 25% of income rather than the 30% now used for federal housing subsidy programs for two reasons: (1) 25% is still the accepted rule of thumb -- used by the National Association of Realtors and others -- for affordability, and the 30% figure was clearly adopted as a way of reducing both the subsidy and the differential between percent of income paid for rent by subsidized and unsubsidized households; and (2) the Bureau of the Census' Annual Housing Survey figures lump together households paying 25-34% of income for gross rent and would require extrapolation to base affordability estimates on 30% of income. If the latter were done, the number of households living in affordable units would obviously increase, but the pattern of lower income people being predominantly those in "unaffordable" units would be sharper.

The reason so many low income households pay so much of their incomes for rent is simple: without subsidy, it is impossible to provide housing at rents which very low income people can afford. At 25% of income, a household with an income of $5,000 can afford only $104 monthly for rent, including utilities. At $7,000, a household can afford $146; at $10,000, the level rises to $208. Except for subsidized housing, it is impossible to provide decent units at these costs.

There are twice as many households with incomes below $5,000 as there are affordable units in the housing inventory. Table 3 below compares renter households and affordable units. It shows, by income class, the number of renter households. It then shows, for 25% and 30% of income respectively, the affordable rents for each range and the estimated number of rental units in these ranges. Chart 4 shows the information for households and units renting for 25% of their incomes. This comparison between low income households and low rent units, stark as it is, understates the affordability problem because a high proportion of these low-rent units are occupied by higher income households paying far less than 25% of their incomes for them.

CHART 4

RENTER HOUSEHOLDS AND UNITS RENTING

WITHIN 25% OF INCOME, 1980

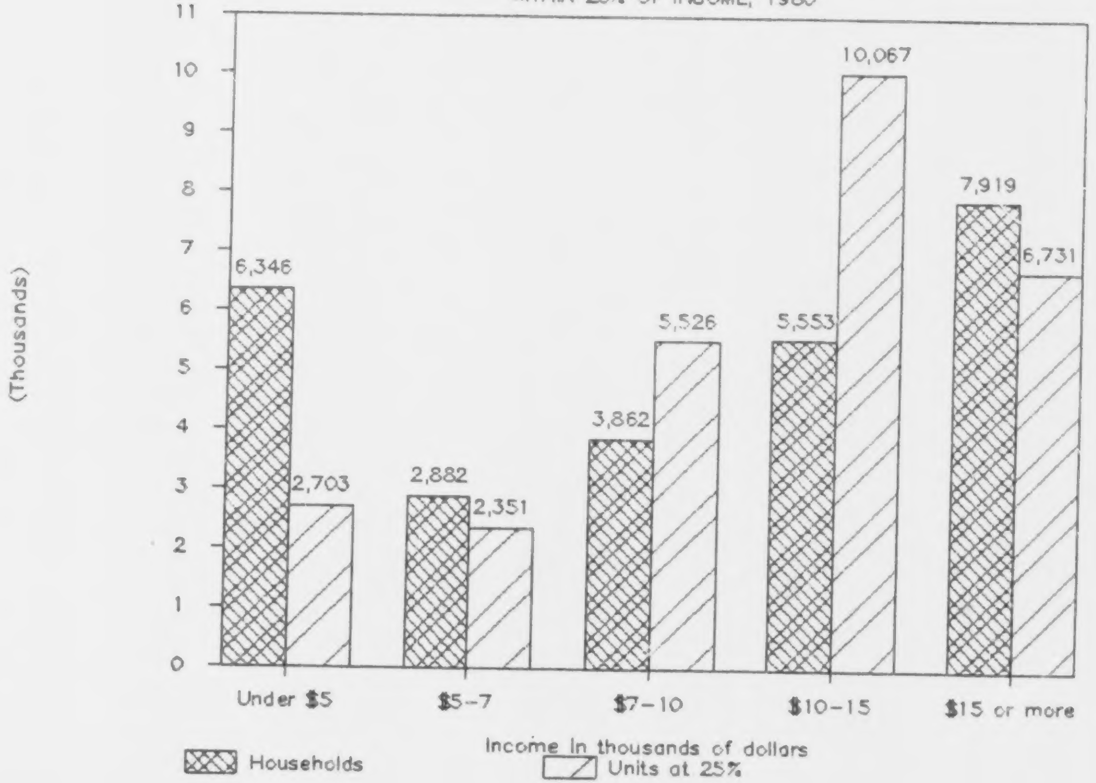


Table 3

Comparison of Renter Households and Rental Units, 1980
(Numbers in thousands)

	Less than $5,000	$5,000 to $6,999	$7,000 to $9,999	$10,000 to $14,999	$15,000 or more
Renter Households	6,346	2,882	3,862	5,553	8,913
Affordable rent at 25%	under $104	$105-146	$147-208	$209-313	$313+
Estimated units at 25%	2,703	2,351	5,526	10,067	6,731
Gap or surplus	-3,643	-531	1,664	4,514	-2,182
Affordable rent at 30%	under $125	$126-175	$176-250	$251-375	$376+
Estimated units at 30%	3,620	3,533	7,587	9,070	3,682
Gap or surplus	-2,726	651	3,725	3,517	-5,233

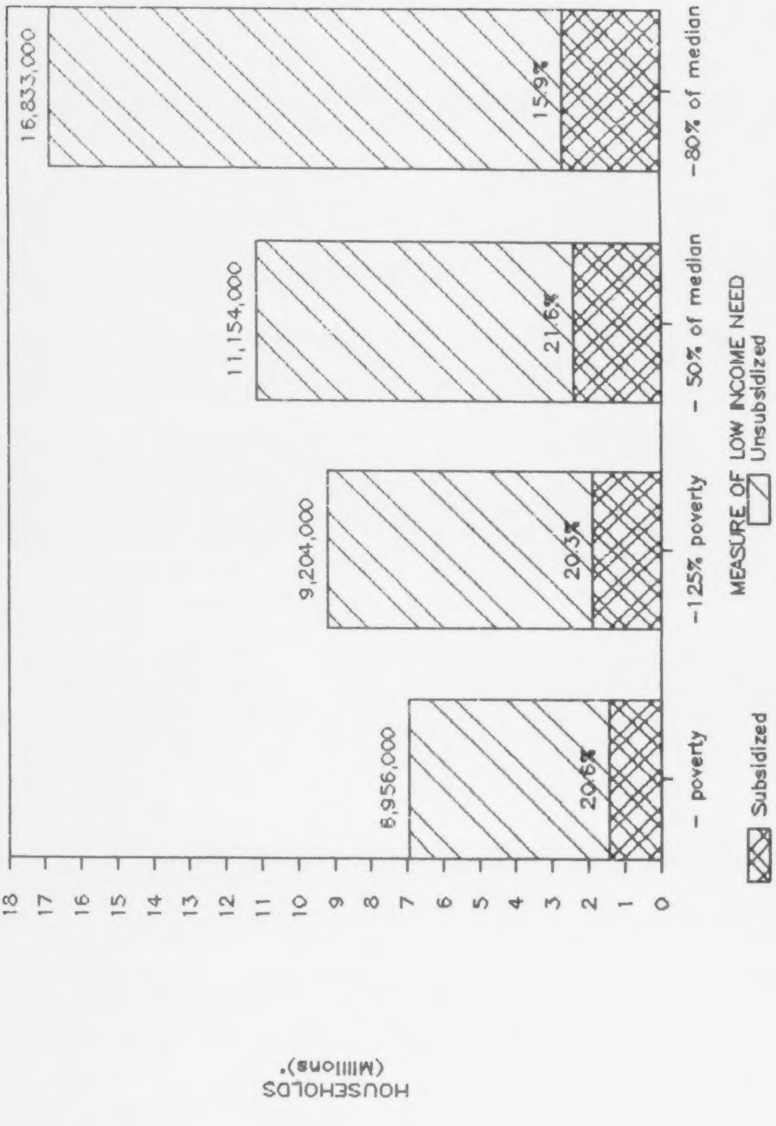
Most low income renter households live in private rental housing, without federal subsidies. Only a small proportion of households eligible for and needing assistance are now living in federally subsidized housing. By whatever measure of need is used, about four fifths of all low income renter households are unable to obtain federal housing assistance.

There are a number of ways of estimating the number of low income households needing housing assistance. One commonly used measure of low income need is the poverty level. A slightly higher standard is 125% of the poverty level. Neither of these criteria has traditionally been used as a measure of need or eligibility for housing assistance. Instead, the Housing and Community Development Act of 1974 set 80% of median family income, as defined by HUD, as the limit for the Section 8 program and defined households with incomes below 50% of median as "very low income." Both of the housing standards include more households than the poverty measures. While none of these threshholds correlates exactly with need, it is significant that the President's Commission on Housing, appointed by President Reagan in 1981, found that three quarters of all renter households with incomes below 50% of median were living in substandard housing, paid more than they could afford for shelter, or both. The other quarter lived in assisted housing. (The President's Commission on Housing, Interim Report, October 1981.)

CHART 5

LOW INCOME RENTER HOUSEHOLDS

BY VARIOUS MEASURES OF NEED, 1980



Regardless of the measure used, only a small proportion of renter households -- after almost half a century of federal low income housing assistance -- are actually receiving it. Only 16% of renters with incomes below the poverty level were living in subsidized housing in 1980. Only 22% of "very low income" renter households and only 15% of "low income" renter households", as defined by HUD, occupied subsidized housing. Chart 5 and Table 4 show the estimated number of renter households under each of these four measures of need in 1980. (The numbers would be roughly doubled if homeowners were included.) The bottom portion of each bar in Chart 5 shows the proportion of renter households living in subsidized housing.

Table 4

Renter Households by Selected Measures of Need, 1980
(Households in thousands)

	Below poverty level	Below 125% of poverty	Below 50% of median	Below 80% of median
Renter households	8,956	9,204	11,154	16,833
In subsidized housing	1,430	1,888	2,405	2,680
Not in subsidized housing	7,526	7,316	8,749	14,153
% in subsidized housing	16.0%	20.5%	21.6%	15.9%

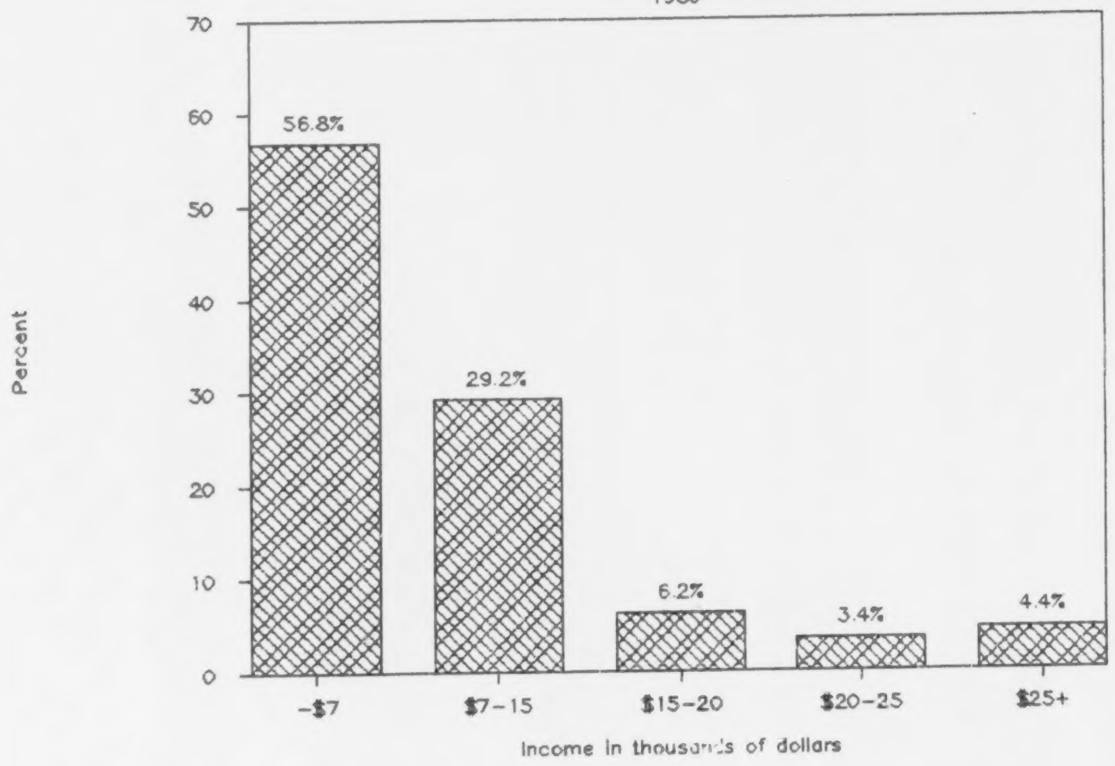
The inability to pay what decent housing costs is reflected not only in the growing number of homeless people and those who fail to pay their rents. It is also reflected in poor housing quality. Although there are almost twice as many owners as renters, more than 63% of all substandard or overcrowded housing was occupied by renters in 1980. And, as Chart 6 shows dramatically, almost three fifths of the renter households living in substandard or overcrowded housing in 1980 had incomes below $7,000. Most of the rest had incomes between $7,000 and $15,000. (The picture for owners is similar: half of the owner households in substandard or overcrowded housing had incomes below $7,000, and almost 90% had incomes below $20,000.)

Given this picture of low income housing needs, what assistance is being provided?

CHART 6

INCOME OF RENTERS IN SUBSTANDARD UNITS

1980



CHAPTER THREE

TYPES OF FEDERAL HOUSING ASSISTANCE

Federal assistance to housing is provided in several major ways: through programs which provide subsidy payments to housing owners; through flexible programs, such as the community development block grant (CDBG) program, where local governments determine the use of funds and apply them to improving housing; through the provision of credit or loan guarantees; and through various provisions of the tax code.

This paper is concerned with the two major types of federal spending for housing: those provided through direct subsidy payment programs and those provided through the tax code. The technical term for the latter is "tax expenditure," a term used by William Simon and Milton Friedman about fifteen years ago.

The Congressional Budget Act of 1974 began to address the issue of the cost of tax expenditures by requiring a listing of all tax expenditures in the Federal budget. These listings have since been contained in a Special Analysis which is an integral part of the President's annual budget proposal. The following explanation appears in Special Analysis G: Tax Expenditures for Fiscal Year 1984:

> The Congressional Budget Act of 1974 (Public Law 93-344) requires a listing of "tax expenditures" in the Budget. The act defines "tax expenditures" as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax or a deferral of liability." The definition of tax expenditures used in this analysis is based on the distinction between the "normal" or "reference" provisions of the tax structure needed to make the tax operational, and the "special" provisions that are exceptions to the reference tax provisions. Such exceptions are designed to further other objectives, such as health care, export promotion, or employment of the handicapped. Their operation is, therefore, comparable to outlay programs, such as milk price supports and rent subsidies that also provide a subsidy to particular activities. For this reason, the expressions "tax subsidies" and "tax expenditures" are often used synonymously. Because the term "tax subsidies" is somewhat more descriptive than "tax expenditures," the former will be used in the remainder of this analysis. (Executive Office of the President, Office of Management and Budget, Special Analyses: Budget of the United States Government, Fiscal Year 1984, p. G-1. Emphasis added)

Estimates of the cost of tax expenditures are available from three major sources: the OMB budget documents, the Congressional Budget Office, and the Joint Committee on Taxation. Unless otherwise noted, the figures in this memorandum are taken from relevant OMB budget documents. In addition, the Department of Housing and Urban Development, in its annual housing production (formerly housing goal) reports, breaks down the homeowner tax expenditures by income groups. These figures have been used here to estimate the cost of tax expenditures. It has been necessary to make some assumptions on the distribution of costs by income group in order to make estimates of the distribution of other direct and tax expenditures for housing assistance. To the extent that these assumptions bias the results, they overestimate expenditures for lower income people and underestimate expenditures for upper income people.

It should be noted that the provisions of the tax code have important interrelationships with each other, so that repeal of any one provision -- or even any combination of provisions -- would not result in recouping the full cost of those provisions to the Treasury. Thus, while it is possible to identify the amount of tax expenditures and estimate their distribution by income group, the task of estimating revenue which would be generated by any changes is more complex. This is also true, to a lesser extent, of direct expenditures. For example, as housing assistance is cut back and homelessness increases, additional resources are going into aid for the homeless, including not just shelter but food and health care.

The major direct federal housing programs are provided either through the Department of Housing and Urban Development (HUD) or, in small cities and rural areas, through the Farmers Home Administration (FmHA) of the U.S. Department of Agriculture. The emphasis of federal low income programs has been on the provision of rental housing. Despite the large number of low income owners, referred to above, there is only one very small federal subsidy program (the very low income repair loan and grant program of the Farmers Home Administration) that directly addresses the housing needs of very low income owners. Two other federal programs, one in HUD (the now-terminated 235 program) and one in FmHA (the 502 program) , do subsidize interest rates for home purchases by people with somewhat higher incomes. In addition, many communities use substantial portions of their CDBG funds for rehabilitation, much of it by low income owners.

As of the end of 1984, approximately four million households were receiving direct assistance through HUD's programs. Outlays for housing payments and public housing operating subsidies to support these units totalled $9.9 billion.

Table 5

Households Living in HUD-Assisted Housing
as of September 30, 1984

	Households	Outlays (in Millions)
Section 8	1,909,812	$ 6,030
Public Housing	1,331,908	2,821
Section 236 (net)	352,620	658
Rent supplements	55,606	110
Subtotal, rental units	3,649,946	9,619
Section 235 home ownership	209,730	270
GRAND TOTAL	3,859,676	9,889

In addition to the 3.8 million households living in HUD-subsidized lower income housing, there are almost three quarters of a million households in small towns and rural areas living in housing subsidized, primarily with interest credits, by the Farmers Home Administration. (Information obtained from the Housing Assistance Council.) Because of the way Farmer's Home programs are funded, it is impossible to provide comparable figures for the 1984 cost of these units. Most FmHA units are financed through loans from the Rural Housing Insurance Fund, which lends money at below-market interest rates. Each year, the fund is reimbursed for losses and some expenses incurred two years previously (the time lag is to permit calculation of the amount based on actual experience). These FmHA loans are supplemented by some grant funds, primarily for rural rental assistance, farmworker housing, and very low income home repairs. Most of the FmHA activities, since they do not involve direct federal subsidy payments, are "off-budget."

Table 6

Households Living in Farmer's Home Subsidized Housing
As of September 30, 1984

502 Home Ownership with interest credits	396,536
504 Very low income repair loans or grants	28,914
Subtotal, homeowners	425,450
515 subsidized rental housing	294,500
514/516 farm labor housing	15,000
Subtotal, rental units	309,500
GRAND TOTAL	734,950

By far the largest federal housing subsidies, however, both in cost to the Treasury and in number of recipients, are those provided through the tax code. In fiscal 1984, the cost to the Federal Treasury of housing-related tax expenditures was estimated by the Congressional Joint Committee on Taxation at $43,665 trillion, based on information provided by the Treasury Department and the Congressional Budget Office (CBO). No current information is available on the number of taxpayers benefitting from these deductions. The 1984 housing-related tax expenditures, as estimated by the Joint Committee using a more inclusive definition of tax expenditures than OMB (and thus obtaining higher cost estimates), are listed in Table 7.

Table 7

Housing-Related Tax Expenditures, 1984
(in millions of dollars)

Historic structure preservation	$ 320
Tax exempt rental housing bonds	1,275
Mortgage revenue bonds	1,785
Accelerated rental hsg depreciation	815
5-year amortization of low income housing rehab	60
Subtotal, investor deductions	4,255
Mortgage interest	23,480
Property taxes	8,775
Capital gain deferral	4,895
Capital gain exclusion	1,630
Residential energy credits	630
Subtotal, homeowner deductions	39,410
TOTAL	$43,665

Although some of the major housing-related tax expenditures contained in the Internal Revenue Code were enacted with termination dates (so they must be extended from time to time), none have been subjected to the kind of review and decision-making by either Congress or the executive branch that accompanies requests for direct housing outlays and budget authority. Moreover, the tax expenditures which have been given attention over the past several years, as Congress has endeavored to raise revenues by closing "loopholes," have been primarily those tax incentives designed to stimulate investment in housing. The major housing expenditures, however, are the homeowner deductions, which dwarf all other housing expenditures, either direct or through the tax system.

CHAPTER FOUR

THE DISTRIBUTION AND COST OF FEDERAL HOUSING ASSISTANCE

Direct federal spending for housing assistance is measured in two ways: (1) outlays or housing payments to support the roughly 4 million units now receiving subsidy and (2) budget authority to extend assistance to an additional number of households.

Outlays or housing payments are a largely uncontrollable expense. Most assisted housing is subsidized under contracts which obligate the federal government to make payments over a five- to forty-year period. Basically the payments cover capital and financing costs, along with some operating assistance.

Budget authority for additional housing assistance is the total federal commitment for future subsidy payments under the assistance contracts. The Congressional Budget Act requires that budget authority for assisted housing be calculated as the maximum annual payment times the number of years of the subsidy contract. Thus, budget authority estimates make low income housing programs appear to be enormously expensive because they represent multi-year commitments. It is equivalent to the cost to an individual purchasing a home with a 15 or 20 year mortgage, if that cost, instead of being calculated as the price of the home, were calculated by including all the principal, interest, taxes, maintenance, utilities and other expenses for the full term of the mortgage. Most new houses would cost well over $300,000 if calculated that way.

Authorizations for additional federal low income housing assistance have declined sharply since 1981 and will go almost to zero if the Administration's FY 1986 budget proposals are adopted. Housing payment and operating subsidy outlays for occupied units have increased somewhat as additional units have been completed and occupied. But the cost of housing-related provisions of the tax code continued to rise, using OMB's estimates (which are substantially below those of CBO or the Joint Committee on Taxation). Chart 7 shows these changes in constant 1985 dollars.

These budget changes have had a severe impact. Reservations for additional low income units under HUD and Farmers Home programs will have dropped from a peak of 541,534 in fiscal 1976 to a projected zero in 1986 under the Administration's proposed 1986 budget. Chart 8 provides the figures for incremental units, including Section 8 existing and vouchers, but excluding loan management, conversions, or additional subsidies for HUD-held properties already receiving subsidies. An increasing proportion of the dwindling additions to HUD units are for existing housing, vouchers, loan management, or conversions of units to Section 8 from other programs, such as rent supplements, as Chart 9 shows.

CHART 7

FEDERAL HOUSING EXPENDITURES, 1981–86

IN CONSTANT 1985 DOLLARS

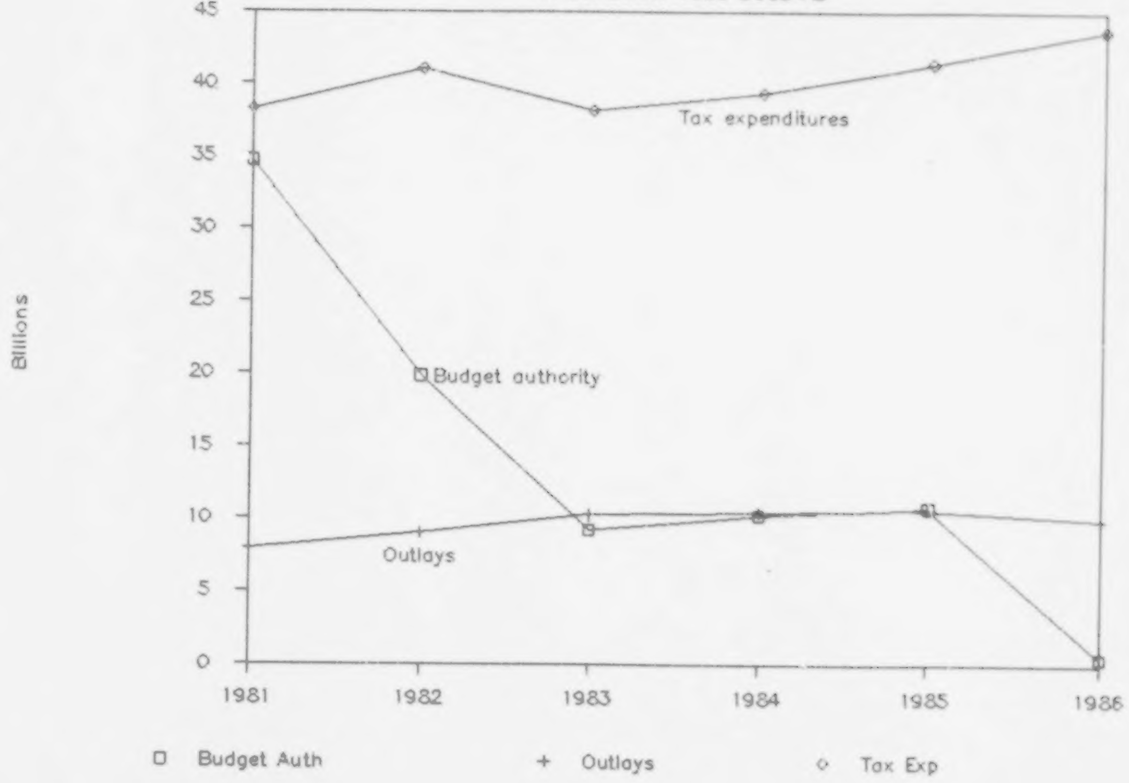


CHART 8

ADDT'L ASSISTED HOUSING UNITS, 1976–86

Incremental HUD and FmHA Units

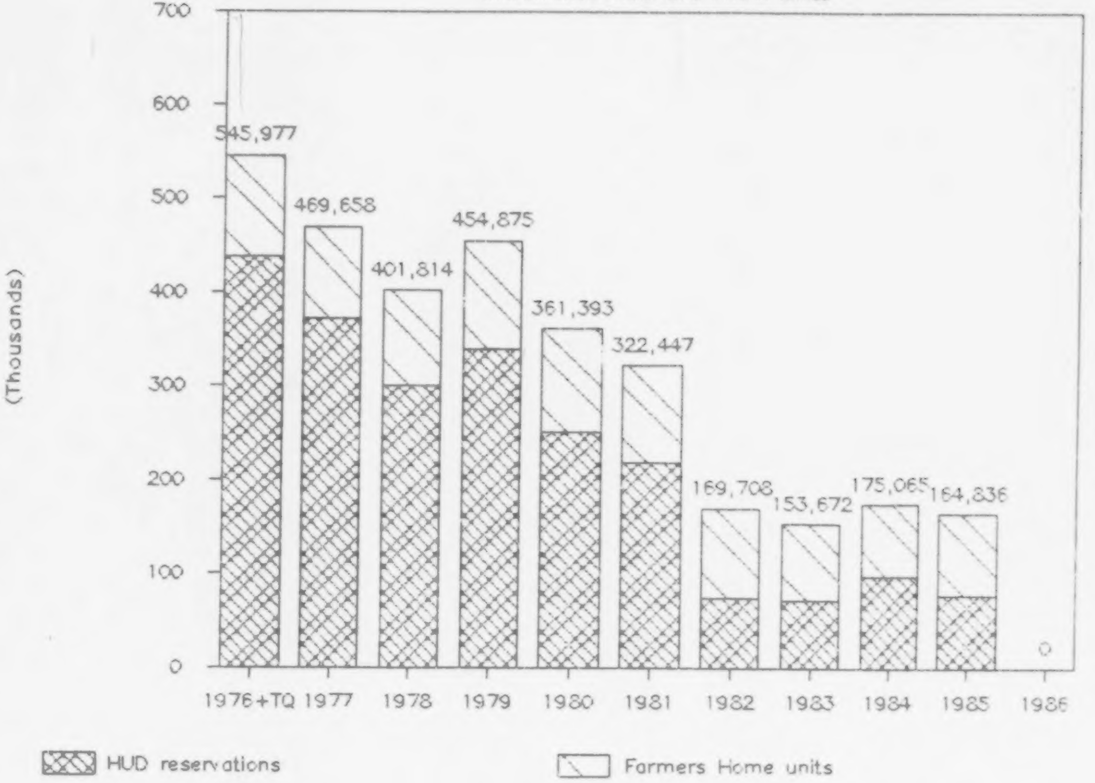
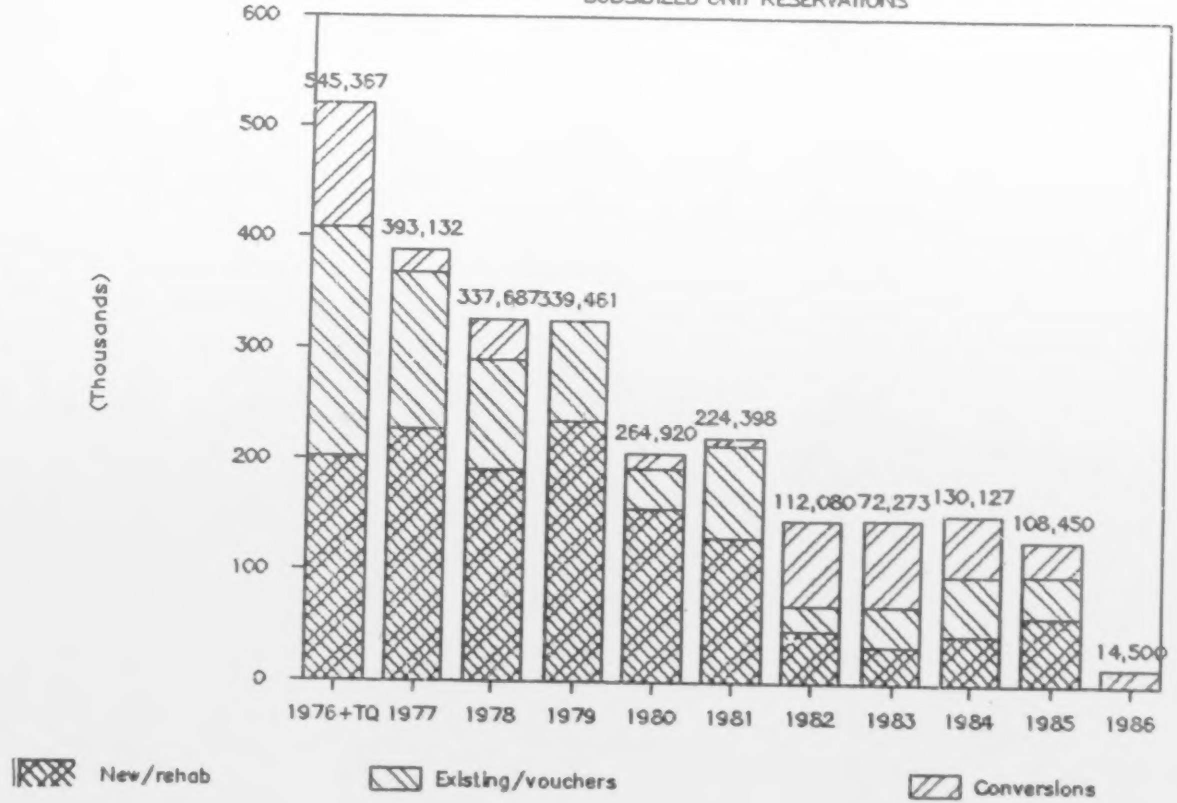


CHART 9

HUD-SUBSIDIZED UNITS BY TYPE, 1976-86



The impact of these changes is only beginning to be felt. As Chart 10 illustrates, there is a substantial lag between reservations, starts, and completions, and units approved several years ago are still being completed and occupied. This flow of additional units will not, however, continue.

In 1981, budget authority (as initially contained in the 1981 HUD appropriation, before cuts and rescissions) for low income housing was $30 billion, outlays for housing payments and operating subsidies for all units under HUD subsidy were $5.7 billion and the estimated cost of housing-related tax expenditures was $33.3 billion. The Administration's budget for 1986 calls for only $0.5 billion in budget authority for low income housing and $10.4 billion in outlays. Housing-related tax expenditures are estimated at $45.6 billion.

Table 8

Federal Housing Expenditures, 1981-86
(in billions of current dollars)

	1981	1982	1983	1984	1985	1986
Budget authority	30.2	17.7	8.6	9.9	10.8	0.5
Outlays	6.9	8.0	9.6	10.0	10.6	10.4
Tax expenditures	33.3	36.6	35.4	37.9	41.4	45.6

It should be noted that these figures understate the magnitude of housing-related tax expenditures because they do not include the failure to tax imputed rent as a homeowner deduction or tax expenditure. Imputed rent is "what a homeowner would receive by renting it (the home) out, less the costs of ownership, taxes, depreciation, and maintenance." (CBO, The Tax Treatment of Home Ownership: Issues and Options, 1981.) If the owner were renting the unit to someone else, s/he would be taxed on this income. The Congressional Budget Office notes that net imputed rental income has never been taxable in this country (although it has been taxed elsewhere) for two reasons: the concept has not been widely accepted by noneconomists and the practical difficulties of estimating the amount. A HUD study estimated the cost of this expenditure to the Treasury in 1979 at $14-$17 billion. It would be substantially higher now. (John C. Simonson, "Existing Tax Expenditures for Homeowners," HUD, 1981, cited by CBO.)

Roughly 90% of the cost of the housing provisions of the tax code are accounted for by homeowner deductions of mortgage interest and property taxes and deferral or exclusion of capital gains on home sales. Homeowner deductions in fiscal 1985 are estimated by the Joint Tax Committee to total $49.3 billion, while investor deductions will cost the Treasury an estimated $5.8 billion. (See Chart 11.) This pattern of housing-related tax expenditures is not substantially different from prior years.

CHART 10

HUD-SUBSIDIZED NEW/REHABBED UNITS

Reservations, Starts, Completions

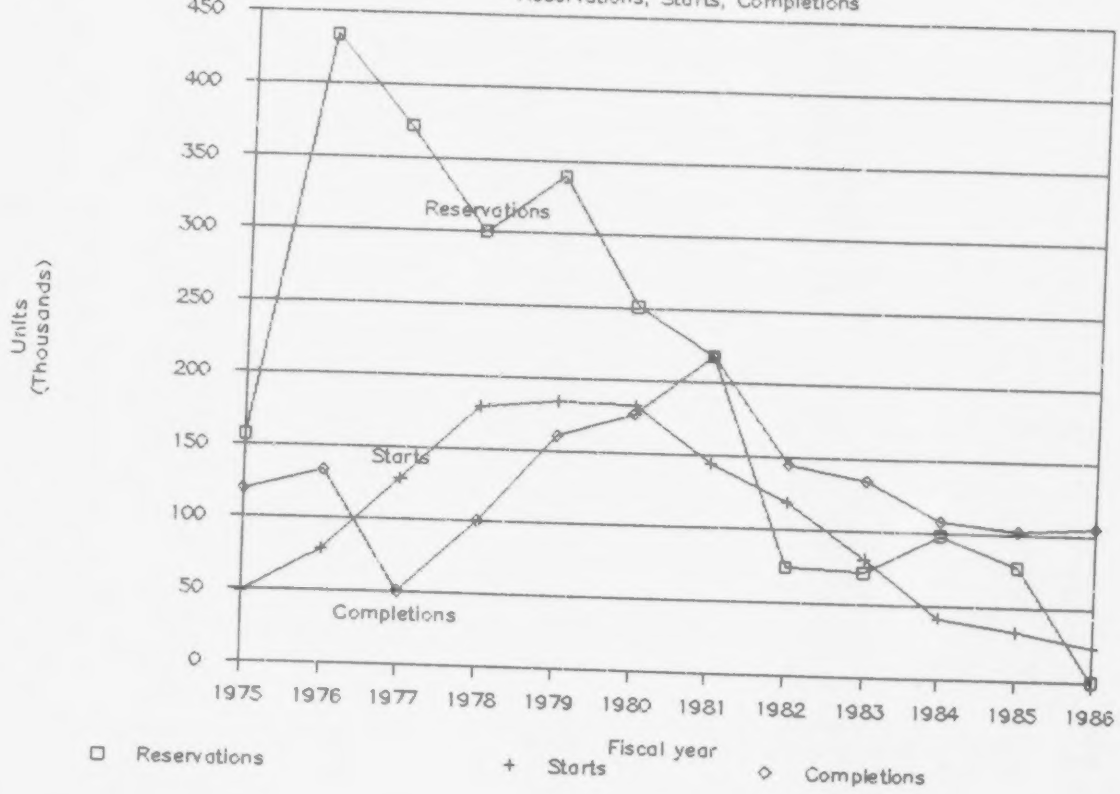
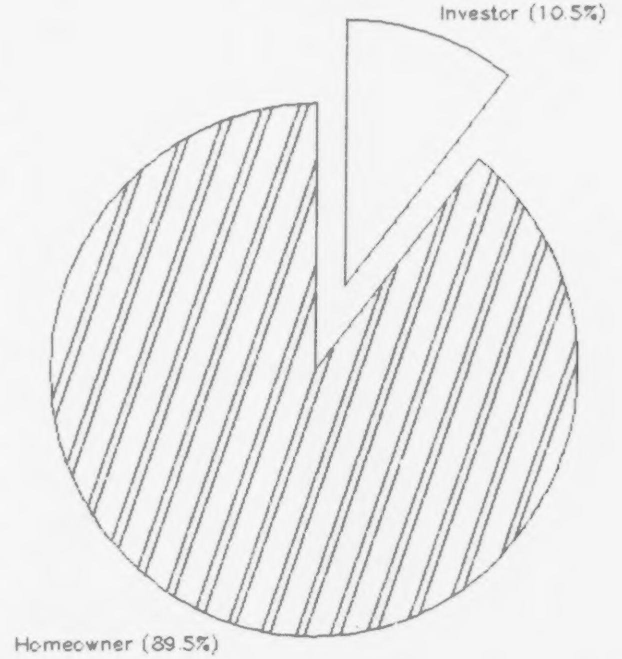


CHART 11

HOUSING—RELATED TAX EXPENDITURES, 1985

(CBO estimates)



This has major implications for tax policy and the impact of various efforts to reduce tax expenditures. In 1983 and 1984, Congressional attention to reducing these expenditures focussed on the investor deductions, while ignoring the far larger homeowner deductions.

The cost of the homeowner provisions of the tax code is increasing far more rapidly than assisted housing payments for lower income people.

While assisted housing payments (subsidies for all occupied units subsidized through HUD programs and the direct payments made by the Farmers Home Administration) have been rising steadily, though slowly, as additional units are subsidized, the cost of the homeowner provisions of the tax code is increasing far more rapidly (See Table 9 and Chart 12). This is not, however, the result of any conscious policy decision on the part of either the Administration or the Congress to increase the federal assistance going to homeowners. Rather, it is the result of the interaction of changes in the economy with the provisions of the tax code. High housing costs, high interest rates, and an increasing number of homes with mortgages account for much of the increase. To a certain extent, the homeowner deductions stimulate borrowing for other purposes. During much of the last ten years, for example, real interest rates have been negative after allowing for inflation and the tax deductibility of interest payments. Therefore, owners had a substantial economic incentive to refinance rather than pay off their mortgages.

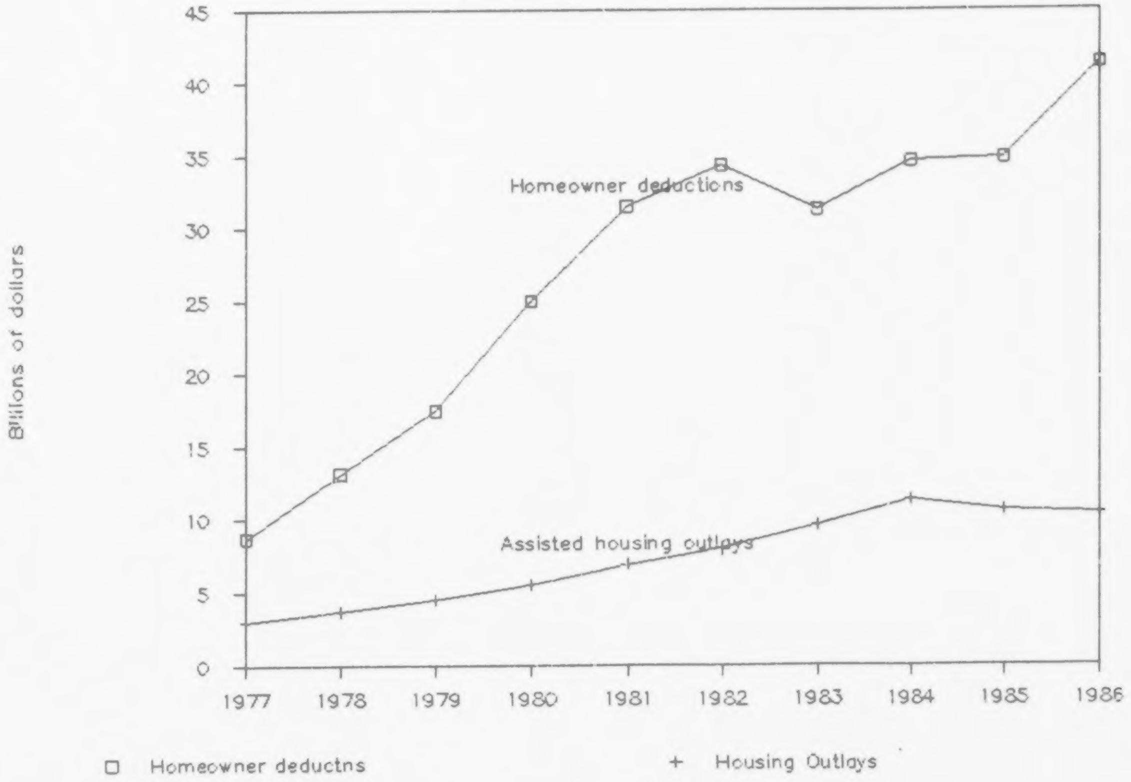
Table 9

Cost of Homeowner Deductions and Assisted Housing Outlays, 1975-86
(in billions of dollars)

Year	Homeowner Deductions	Assisted Housing Outlays
1975	9.9	2.1
1976	8.9	2.5
1977	8.7	3.0
1978	13.1	3.7
1979	17.5	4.5
1980	25.0	5.5
1981	31.5	6.9
1982	34.3	8.0
1983	31.3	9.6
1984	34.6	11.3
1985	34.8	10.6
1986	41.3	10.4

CHART 12

HOMEOWNER DEDUCTIONS AND ASSISTED HOUSING PAYMENTS



It is worth noting that the homeowner provisions in the tax code were not, with the exception of the capital gains provisions, inserted in order to provide assistance for homeownership. On the contrary, they are the result of a definition of income, which excluded interest and state and local tax payments, and which was included in the tax code when it was first enacted in 1913, having been carried over from an emergency income tax enacted during the Civil War. Until the broadening of the tax base and the rise in homeownership following World War II, it had little impact.

Unfortunately, accurate figures on the number of homeowners benefitting from homeowner deductions are hard to come by, because data on homeownership are kept by household and data on tax deductions are kept by taxpayer, and many households have more than one taxpayer. Nonetheless, it is clear that fewer than half of all homeowners claim mortgage interest and property tax deductions. In 1981, 26,425,000 taxpayers claimed these deductions; this is 48.6% of the total number of owner-occupied units in the inventory that year. (This figure overestimates the proportion of owners using the deductions, since some owner households had more than one taxpayer claiming these deductions).

Upper income people receive a disproportionate share of total federal housing expenditures.

In 1981, one quarter of all households had incomes below $10,000, but they received only one-eighth of all federal housing assistance (direct and through the tax code). Lower middle income households -- 27% of all households -- received only 7% of all housing assistance. At the other end of the income distribution, one quarter of all federal housing assistance went to the 7% of all households with incomes above $50,000 and 43% of the assistance went to the 20% of households with incomes between $30,000 and $50,000. Chart 13 and Table 10 show the relative distributions of households and housing subsidies, by income class, while Table 11 and Chart 14 show the number of subsidy recipients in 1981.

Table 10

Estimated Distribution of Households and Federal Assistance By Income Group, 1981

Income Group (in thousands)

	Under $10	$10-20	$20-30	$30-50	Over $50
Households	25.4%	26.7%	21.1%	19.6%	7.2%
Subsidies	12.6%	6.9%	12.8%	43.5%	24.2%

CHART 13

HOUSEHOLDS AND HOUSING SUBSIDIES, 1981

Distribution by income group

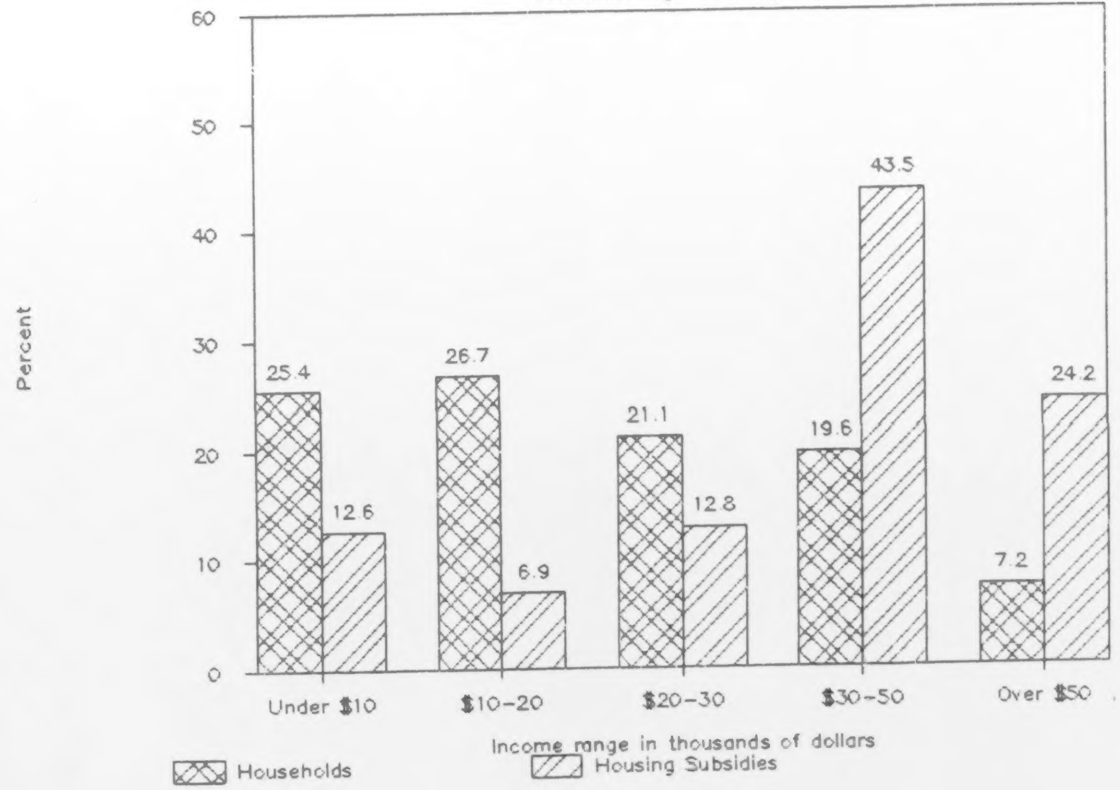
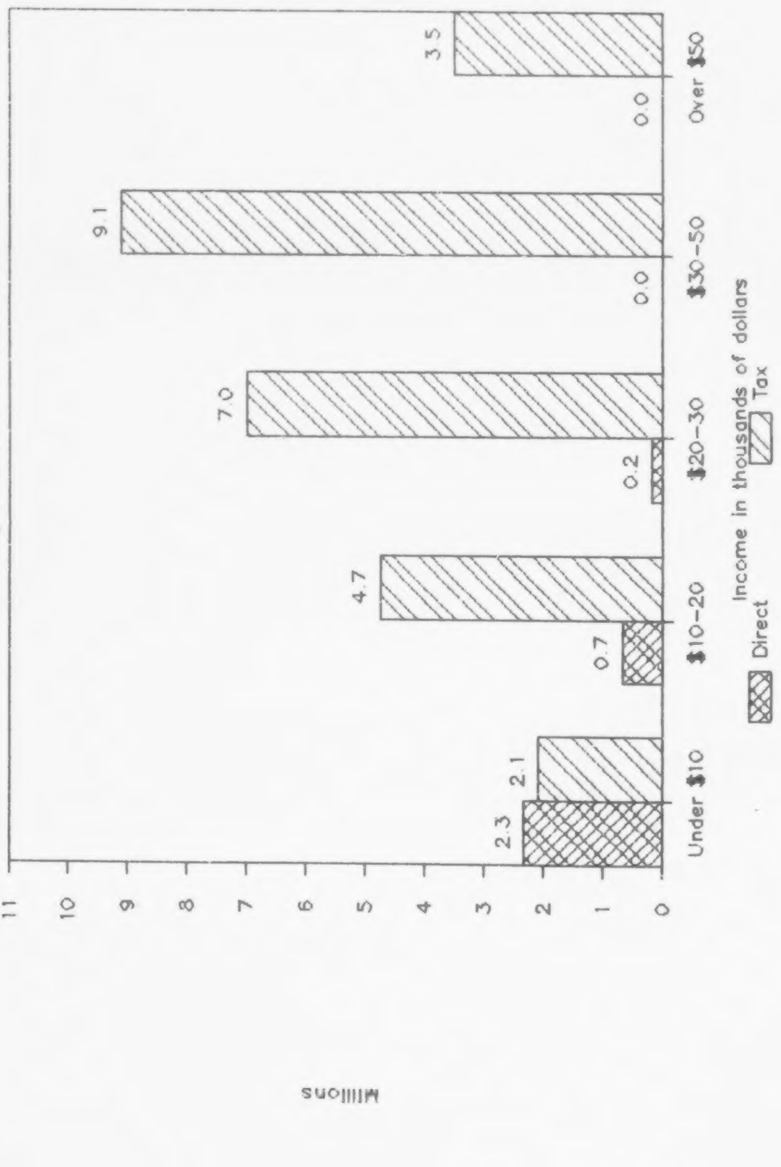


CHART 14

HOUSING SUBSIDY RECIPIENTS, 1981

showing direct and tax subsidies



The proportion of households receiving federal housing assistance, either directly or through tax expenditures, rises as income increases. Only a one-eighth of taxpayers with incomes below $10,000 receive housing assistance and about half of this assistance is direct (that is, federal housing assistance payments on behalf of these households to owners of subsidized units). About one fifth of all taxpayers with incomes between $10,000 and $20,000 receive housing assistance, primarily through the tax code. In contrast, two thirds of all taxpayers with incomes between $30,000 and $50,000 and more than four fifths of those with incomes above $50,000 receive housing assistance through the tax code. Chart 15 shows the number of taxpayers, by income group, receiving housing assistance. (Since there are often two taxpayers in the same household, the total number of taxpayers is greater than the number of households.)

Table 11

Total Taxpayers, by Income, and Recipients of Tax and Direct Housing Subsidies, 1981
(Millions of households)

	Income in thousands of dollars				
	Under $10	$10-20	$20-30	$30-50	Over $5
Taxpayers	34.6	24.3	17.1	13.4	4.1
Receiving tax subsidies	2.1	4.7	7.0	9.1	3.5
Not receiving tax subsidies	32.5	19.6	10.1	4.2	0.6
Housing subsidy recipients					
Tax subsidies	2.1	4.7	7.0	9.1	3.5
Direct subsidies	2.3	0.7	0.2	0.0	0.0
TOTAL	4.4	5.4	7.2	9.1	3.5

Moreover, the average amount of assistance per household rises with income. In 1981, the average amount of federal housing expenditures per household was $10.40 per household per month for households with incomes under $10,000, rising to $155.54 per household per month for households with incomes above $50,000 (See Table 12 and Chart 16).

CHART 15

TAXPAYERS BY INCOME GROUP, 1981

with number getting tax subsidies

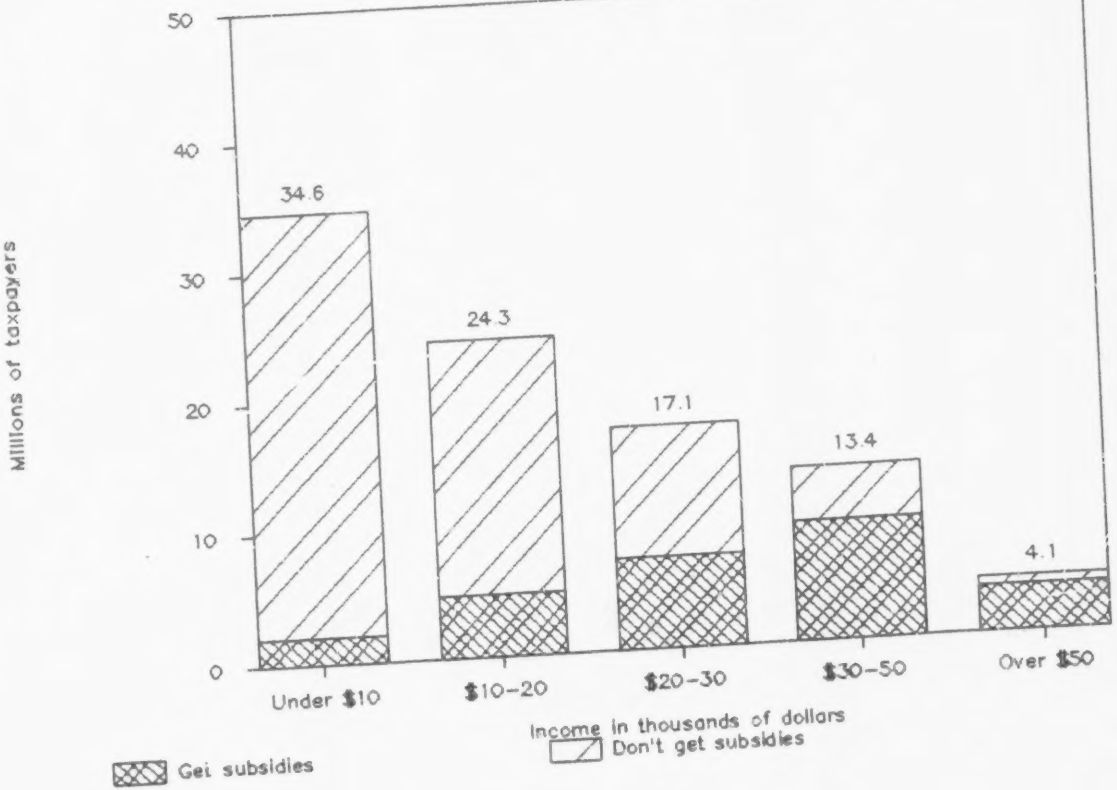


CHART 16

AVERAGE MONTHLY HOUSING SUBSIDIES

PER HOUSEHOLD IN INCOME CLASS, 1981

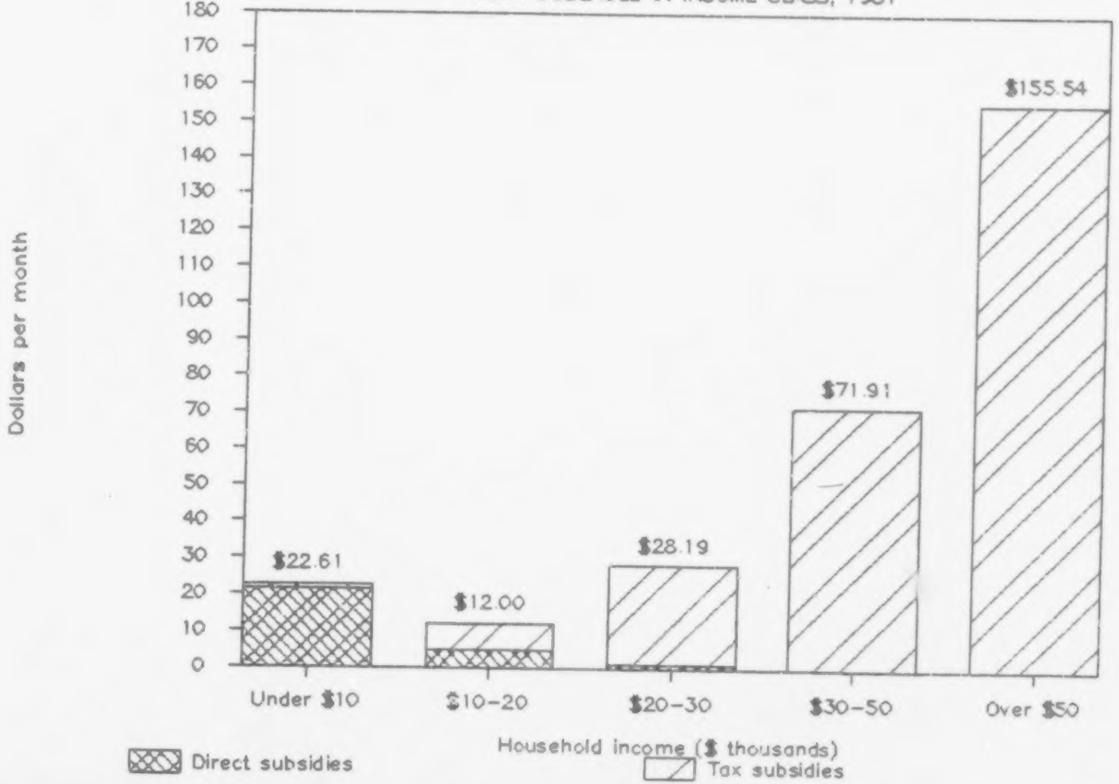


Table 12

Total and Average Subsidies by Income Group, 1981

	Under $10,000	$10,000-$20,000	$20,000-$30,000	$30,000-$50,000	Over $50,000
Total households (000's)	21,229	22,293	17,600	16,413	5,992
Direct subsidies					
Households in assisted housing (000's)	2,182	557	134	0	0
Estimated total direct housing subsidies (000,000's)*	$5,455	$1,272	$214	$0	$0
Average per assisted household*	$257	$57	$12	$0	$0
Average per month	$208.34	$190.37	$133.33	$0.00	$0.00
Average per household in income class	$257.00	$57.00	$12.00	$0.00	$0.00
Average per month	$21.41	$4.76	$1.02	$0.00	$0.00
Average per recipient	$1,353	$322	$835	$1,553	$3,200
Tax subsidies					
Households claiming tax subsidies (000's)**	2,075	4,740	6,996	9,119	3,495
Estimated total tax	271	144	338	863	1866
subsidies (000,000's)	$305	$1,938	$5,739	$14,164	$11,184
Average per household receiving tax subsidy	$147	$409	$820	$1,553	$3,200
Average per month	$12.25	$34.07	$68.36	$129.44	$266.67
Average per household in income class	$14	$87	$326	$863	$1,866
Average per month	$1.20	$7.24	$27.17	$71.91	$155.54
Total subsidies					
Total tax and direct subsidies (000,000's)	$5,760	$3,210	$5,953	$14,164	$11,184
Total recipients (000's)	4,257	5,297	7,130	9,119	3,495
Average per recipient	$1,353	$322	$835	$1,553	$3,200
Average per month	$13.88	$11.01	$29.08	$87.11	$226.93
Average per household in income class	$271	$144	$338	$863	$1,866
Average per month	$22.61	$12.00	$28.19	$71.91	$155.54

*Subsidies allocated arbitrarily to tilt slightly toward lower income.
**Households claiming homeowner deductions; these estimated totals are probably too high.

Source: Estimated by Low Income Housing Information Service from official government documents.

There is a myth that low and middle income homeowners are the chief beneficiaries of homeowner deductions. The facts do not support this. Although about two thirds of all households are homeowners, only 28% of the tax returns filed in 1981 claimed homeowner deductions. This was primarily because the majority of taxpayers do not itemize their deductions. Most low income owners own free and clear, so they do not have mortgage interest deductions to claim. For others, incomes and marginal tax rates are so low that it does not pay them to do so. Therefore, they do not benefit from the homeowner provisions. (Part of the low percentage is also because some households have more than one taxpayer, but this is a small part of the difference.)

The magnitude of the subsidy imbalance is such that a more equitable approach to federal housing assistance could provide a substantial portion of the funds needed to deal effectively with the critical housing needs of low income people. For example, Anthony Downs has estimated that a reduction of only 14% overall in homeowner deductions for mortgage interest and property taxes would produce enough revenue to fund a full-scale, entitlement housing allowance program. (Rental Housing in the 1980's.)

Senator DURENBERGER. On the issue of deductibility of State and local taxes, is there anyone here who would support selective elimination of deductibility? Or do you have positions against that sort of thing? Bradley-Gephart eliminates deductibility on sales taxes. Kemp-Kasten eliminates it on income taxes and sales taxes. Is there any association here that has taken a position against the selective elimination of deductibility?

Ms. KLINGER. We really believe that the deductibility for all of those items need to be left. On the property tax deduction, of course, that's the difference between homeownership and renting for thousands of people in this country, whether or not they are going to qualify for allowance. We could not support that kind of—we've had our vote just last week and it's clear on deductibility across the board our association has spoken.

Senator DURENBERGER. Did you discuss my bill on the 1 percent of adjusted gross income at all?

Ms. KLINGER. That I have such esteem for, Senator Durenberger, and I am serving on the Treasury Advisory Group on Federal, State, and Local Fiscal Relations and that was a mandate in your last bill. And I regret to inform you that we cannot support that position.

Senator DURENBERGER. So you are going to stiff this whole process? I mean isn't that a fair summary of——

Ms. KLINGER. I would not characterize it as stiffing the whole process. I think we are here to work with Congress. We talked before about what was on the table made a difference in whether something was revenue neutral or not. We're really talking about the survival of State and local government. In particular, county governments. And I could list you example after example and would be happy to provide you with some statistics from the Central Valley of California telling you about our 8,000 Mong that have moved into a county of 150,000 population in the last 3 years in a secondary migration; go on at great length about our unemployment and about how much we need the IDB's to begin to do what other counties across the country were doing for years. And that is generate more jobs and not be dependent on agriculture. We would welcome the opportunity to have that kind of individual discussion. I know you don't have time this morning.

Senator DURENBERGER. Is there anyone else who has a position one way or another on selective——

Mayor MORIAL. The Conference of Mayors has taken no position on selective deductibility.

Senator DURENBERGER. The conference?

Mr. MARCHI. No categorial position for the people I am representing here today.

Senator DURENBERGER. And the League?

Mayor VOINOVICH. That's the bottom line.

Senator DURENBERGER. OK.

Pat, did you want to say something?

Senator MOYNIHAN. I just wanted to say, Mr. Chairman, this has been a curve set of hearings. And I want to thank this staff that put them together, and especially thank our colleagues who joined us. You have honored this committee by your testimony and your good spirits throughout.

Senator **Durenberger**. Thank you all. And the hearing is adjourned.

[Whereupon, at 12:39 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

The Impact of the Elimination of Deductibility of State and Local Taxes on Higher Education

Written Statement for the Senate Committee on Finance

On Behalf of the

American Association of State Colleges and Universities
and the
American Council on Education
American Association of Community and Junior Colleges
Association of American Universities
Association of Urban Universities
The City University of New York
National Association of State Universities and Land-Grant Colleges

August 4, 1985

Mr. Chairman and Members of the Finance Committee:

As the Committee on Finance deliberates general tax reform, the impact on colleges and universities must be carefully considered. Higher education has a number of concerns regarding the effects of the President's tax reform proposal on colleges and universities. Among those concerns are charitable giving, employee educational assistance, and tax-exempt bonds. You have heard about these in earlier testimony before the Finance Committee, in testimony to be given at later dates, and in written testimony submitted to the Committee on July 9th by the American Council on Education on behalf of the higher education community.

The **deduction for state and local taxes** is a major part of the overall concern of the higher education community, and it is of particular concern for all public two and four-year colleges. In whatever tax reform proposal you report from this committee, we urge you to retain the full federal deductibility of all current state and local tax payments.

Within the fifty states, deductibility now helps foster a diverse system of higher education; of public and private two and four-year institutions, of vocational and technical institutions, and of public and private graduate and research universities. State and local governments provide the largest single share of funds to our public institutions for important reasons: the necessity for an educated citizenry and workforce, equality of educational opportunity, and the research capacity to solve regional, state and national problems. These reasons are now accepted as public policy, and they have become such a staple of state expectations that higher education has attained the position as the third or fourth single largest item in the budgets of most states.

Recent years have not been easy ones for many public colleges and universities and for many private colleges and universities as well. National and state recessions and dramatic changes in energy prices and industrial composition have had major consequences for the economic health of many states, consequently state tax collections, and thereby state funding for higher education.

The financial resiliency of many of our states was recently evidenced when many state economies rebounded from a difficult period. A number of states revived their own state finances with the difficult decision to raise state income taxes. The economic recovery in many of our states and the improved fiscal condition of state finances will hopefully be long lasting and spread to the other states experiencing current fiscal difficulties. Hopefully, it will be sustained because simultaneously a renewal at all levels of education is beginning to occur within the states and new and needed monies are beginning to be reinvested into education.

The credit for educational renewal is shared by state political and educational leaders, the citizens who have thus far shown a willingness to support education, and the President and his administration for creating the National Commission on Excellence. Many states have raised taxes solely to support education. Furthermore, sustained economic recovery in the states is now viewed as inseparable from the strength and quality of the state public higher education system. This renewal and new investment is now being placed in jeopardy by the President's proposal to repeal the federal deduction which is permitted for state and local taxes.

Econometric projections of declines in state and local spending due to the elimination of deductibility vary in magnitude, but all point to a reduction in the size of state and local government and their services. Education is the largest service, comprising nearly 40% of state and local government budgets. Higher education is nearly a third of state government expenditures for all of education. Anything that confounds the fiscal flexibility of the states or indirectly suppresses the ingenuity and fiscal resiliency of the states is going to have negative effects felt first and foremost in education.

Taxpayer reactions to the increased cost of state services due to the elimination of deductibility makes public education-and in some states private education-highly susceptible to funding reductions. This applies to property taxes which in 1983 provided some $120 billion to our local schools and $8 billion to our community and junior colleges. And eventually the effects will be felt in our state sales and income taxes that are the primary drivers of state budgets and which are used to support anywhere from 30% to 80% of the budgets of two-year, four-year, and graduate public colleges and universities in the amount of $36 billion per year.

When the eventual effects of deductibility's elimination are felt in state budgets, it will be higher education that will unfortunately experience reductions first. The nature of the direct appropriations process to state higher education institutions makes our budgets a more likely target for reduction than "committed" funds for state entitlements, requirements for federal matching grants, state employee insurance and retirement, and bond indebtedness. We have estimated that by even by the modest declines in state spending projected by the Advisory Commission on Intergovernmental Relations, higher education nationally would experience an annual decline in 1983 dollars of one to two billion dollars.

The Education Commission of the States (the interstate compact for education based in Denver whose primary constituents are governors and state legislators chairing education committees) and the National Governor's Association, are about to launch state efforts to improve the effectiveness of postsecondary education. These efforts will consist of a series of recommendations to lawmakers and educators in time for the 1986 legislative sessions. These efforts will concentrate on quality and innovation, and reward new institutional-initiated reforms, as well as those already in place. They will seek to strengthen the ties between institutions and their state governments. It is this type of renewal and search for the margin of excellence; new monies for state-of-the-art laboratory and instructional equipment, competitive faculty salaries, centers of excellence grants, and endowed chairs that will be jeopardized by the effects of the loss of deductibility. The Education Commission of the States has realized this negative effect and has passed a Commission resolution at its July Annual Meeting in Philadelphia urging Congress to retain deductibility. The National Governor's Association has testified before the Finance Committee strongly opposing total elimination of deductibility as proposed by President Reagan.

There is a less visible effect that the end of deductibility could have on higher education. The level of state support that colleges and universities receive has a direct bearing on the tuition level that colleges and universities must eventually charge. AASCU institutions have a strong commitment to educational opportunity that is reflected in concern over the barriers to education that costs may pose for all students, particularly students from low-income and minority families. Low to moderate tuition is one of the major ways to provide educational opportunity. Since 1980, tuition increases have doubled those of consumer goods and services. With the repeal of deductibility and consequent growing tax resistance, ultimately pressure to raise tuition further would grow. If tuition continues to increase as a percentage of educational costs due to state funding reductions, further limits to educational opportunity will result. A study by AASCU released in March showed that from 1975 to 1981 the Black and Hispanic percentage of total enrollment in higher education declined, 11 percent and 16 percent respectively.

The evolution of our federal tax system is intertwined with the Constitution and our system of federalism. It is in the provision of education that there is a delicate federal/state balance. The Constitution does not mandate that the federal government provide Americans an education-that is traditionally the role of the states.

We believe that the retention of full deductibility can be accomplished within the context of tax reform. The support that deductibility provides education is a worthwhile tax deduction. The state and local tax dollars redistributed to citizens enrolled in public education and in public higher education eventually are for the benefit of all of society. Eliminating deductibility and the support in now provides education is bad federal tax policy and thus bad public policy.

STATEMENT

of the

AMERICAN JEWISH CONGRESS

on behalf of itself,

the

NATIONAL JEWISH COMMUNITY RELATIONS ADVISORY COUNCIL

and the

NATIONAL URBAN COALITION

before the

SENATE COMMITTEE ON FINANCE

for the hearing on the

DEDUCTIBILITY OF STATE AND LOCAL TAXES

American Jewish Congress
15 East 84th Street
New York, N. Y. 10028

August, 1985

STATEMENT
of the
AMERICAN JEWISH CONGRESS
on behalf of itself,
the
NATIONAL JEWISH COMMUNITY RELATIONS ADVISORY COUNCIL
and the
NATIONAL URBAN COALITION
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SENATE COMMITTEE ON FINANCE

Introduction

The American Jewish Congress, a national membership organization of American Jews concerned with human rights and social justice for all, welcomes this opportunity to present its views on the deductibility of state and local taxes. We are submitting this statement on behalf of our organization, the National Jewish Community Relations Advisory Council and the National Urban Coalition.

The National Jewish Community Relations Advisory Council, and its following national member agencies, join in this testimony: B'nai B'rith, Hadassah, Jewish Labor Committee, Jewish War Veterans of the U.S.A., National Council of Jewish Women, Union of American Hebrew Congregations, Union of Orthodox Jewish Congregations of America, United Synagogue of America -- National Women's League for Conservative Judaism, Women's American ORT, and the 113 community member agencies representing all major Jewish communities in the United States. The American Jewish Committee has not had sufficient opportunity to consider this testimony and therefore does not participate in it.

The National Urban Coalition has 42 affiliates based in 35 cities and 20 states and the District of Columbia. It came into existence in the wake of the urban riots in 1967 and was formed by a convocation of business, labor, community and government leaders who shared a common concern -- the health, vitality and stabilization of our nation's cities. Today the National Urban Coalition and its affiliates work to improve the quality of life for the economically disadvantaged residents of our country's urban areas.

Tax reform is an urgent national need. The tax system must be made simpler and more equitable. Neither anyone nor any group has a vested right in tax benefits granted by current law. Whether a particular benefit is to be retained must be analyzed in terms of the goals it serves, and whether it is compatible with the twin goals of fairness and simplicity.

There are two major reasons for our interest in testifying with respect to the proposed elimination of the deduction of state and local taxes from Federal income taxes. The loss of deductibility would inevitably lead to a decline in resources used to address the problems of the needy and poor. In particular, education and social welfare programs would suffer from lower budgets.

As community relations agencies, we are not only concerned with the potential for specific substantive cuts, but also with how these would affect relations between racial and ethnic groups. Since many of these groups are heavily dependent upon state and local taxes for considerable funding for programs that are important to them, we fear that cutbacks would exacerbate intergroup conflicts as competition for scarce funds intensifies.

Deductibility and the Consequences of Its Elimination

The argument that deductibility solely benefits high tax states is specious. Integral to our Federal system is the view that Congressionally enacted programs may impact differently on each state. For example, Federal assistance for fires, tornadoes, floods and other disasters is more likely to go to some states than to others. This is as it should be. As Justice Cardozo stated, "in the long run prosperity and salvation are found in union and not division."

The interconnected nature of our society is another important consideration. Funds allocated to education in Alabama or Montana affect the well-being of all Americans. So too do a myriad of other programs whose primary responsibility is in the hands of state and local governments.

The United States has for a long time believed in helping state and local governments use their taxing powers to provide services to their constituents. When an emergency

Federal income tax was enacted at the height of the Civil War, local taxes were deductible. Furthermore, deductibility has been part of the Internal Revenue Code since the 1913 adoption of a Federal income tax. It was enacted to prevent double taxation and to allow state and local governments to raise taxes and avoid the higher tax rates that would result from combining Federal, state and local taxes.

The Treasury Department's proposal to repeal the deductibility of taxes paid to state and local governments would severely hamper their ability to fund vital programs for their constituents. Almost immediately, it would fire a revolt by taxpayers, similar to California's Proposition 13, to lower state and local taxes since these would become more costly in after-tax dollars. Such a revolt would have a strong chance of success. Some 33 million households take the deduction for state and local taxes, a figure nearly 3 million above the number deducting for charitable contributions and 8 million more than those deducting for home mortgage interest.

Let us be clear with respect to the programs that will be affected by a more limited ability of state and local governments to raise revenues. It is not that the loss of deductibility would make it "more difficult for states to finance programs of doubtful benefit to their taxpayers," as suggested in a recent paper by the Heritage Foundation. Lower income groups would be severely harmed by reduced appropriations for basic welfare and Medicaid programs, programs which historically, have not been politically popular.

The middle class may be willing to accept this at first. However, their turn for concern would come when programs for education, recreation and parks are cut. Education, which receives over 90 percent of its funds from state and local governments, accounts for nearly 40 percent of overall spending by these jurisdictions.

In many communities, education is the government program that the taxpayer is most capable of influencing. When one considers that only 28 percent of America's adults have children in the public schools, it becomes especially clear that the repeal of deductibility would lead to fierce pressure on local school boards to cut costs.

Two years ago, in A Nation At Risk, the President's National Commission on Excellence in Education concluded that the basic responsibility for financing schools was held by state and local officials. With the loss of deductibility, the resources allocated to our schools would decline and make improvements in their quality virtually impossible. Financially able parents would be more likely to opt out of the public schools and choose to send their children to private institutions. Ironically, a voluntary contribution by these parents to their children's schools may be tax deductible, while deductions could not be taken for mandatory taxes to support public schools.

The loss of deductibility would also have a negative impact on the related areas of housing and a community's tax base and credit rating. If a home, for example, would cost $1,000 more a year to maintain, its value would decrease since there are fewer buyers who would be able to pay for its purchase and upkeep, including real estate taxes. This would reduce that home's assessed value and the town's aggregate tax base, thus generating less income. The latter would lead to a lower credit rating for that community and increase its borrowing costs. Thus, according to a recent Merril Lynch study on the impact of the elimination of deductibility, many "bonds will have new vulnerabilities which could result in significant credit deterioration."

All of these reasons may explain why Congressman Jack Kemp has introduced legislation to keep the deduction for property taxes. Such a proposal is subject to abuse, however, since it could lead to state and local governments lowering income and sales taxes and replacing them with a rise in deductible real estate taxes.

Nationally, the Advisory Commission on Intergovernmental Relations estimates the annual per capita value of deductibility at $120 per year, ranging from a low of $33 in South Dakota and Tennessee to a high of $263 in New York, Ostensibly, as some proponents of the proposed change have argued, it would appear to be unfair to require the lower tax states to subsidize those with higher taxes. However, this ignores the fact that national policies forced some states to "exercise their option" to tax at a higher rate because they have greater concentrations of the poor, as well as illegal aliens and drug related problems that stem from the Federal government's failure to enact a sensible immigration policy and to interdict controlled substances at our borders.

If we look at a different set of data, the per capita difference between the amounts states send to the Federal treasury and the amount Washington returns in expenditures, a very different perspective emerges. As mentioned above, the per capita value of deductibility to residents of South Dakota and Tennessee is $33. According to 1984 figures compiled by State Policy Research, these states respectively receive $667 and $557 per capita above what they paid into the Federal treasury. New York, the big "gainer" on deductibility, lost $232 per capita.

Deductibility evens out differences in tax burdens between states. With repeal, higher tax states would become less economically competitive, and their residents would be strongly tempted to relocate to lower tax areas, especially if the latter are geographically close by. The Administration cannot be unaware of this since it has often expressed support for enterprise zones, one of the key underpinnings of which is that by reducing taxes and other charges, business would be encouraged to relocate to areas that they have historically found less desirable. Just as these tax incentives would lead to relocation of business to enterprise zones, so too would the higher taxes necessitated by the loss of deductibility lead to the relocation of economically better off taxpayers to lower tax areas. Left behind would be a greater concentration of the less mobile low and moderate income families and a depleted tax base.

Last December, on the Cable News Network, then Secretary of the Treasury Donald T. Regan said he "lacked sympathy for high-tax states trying to protect their wealthy taxpayers." Over half of American taxpayers in 1982 who deducted for state and local taxes had incomes below $30,000. Eighty-seven percent of them earned less than $50,000. The elderly, in particular, would be harmed since they have larger average deductions for state and local taxes -- partly because many of them have paid off their home mortgages -- relative to the deductions listed by other taxpayers. Most affected families would be quite surprised to find out that they are wealthy (hopefully, none of them are supporting a child in college!).

The White House and the Treasury have asserted that without the substantial revenues from the elimination of the state and local tax deductions, the whole tax reform package would be in jeopardy. We reject this formulation. Deductibility becomes the foundation of tax reform only if one accepts the way the Treasury's tax package was drafted. Deductibility could be retained if adjustments were made in other parts of the proposal, including a substantial tax on imported oil.

And how would this proposal relate to the President's interest in shifting functions and responsibilities from the national level to state and local governments? When joined with earlier and recently proposed budget cuts, what would occur is a mere shifting of responsibilities without the financial means to provide for their implementation. States, counties, cities and school boards would find it impossible to implement their existing responsibilities, much less those that would be transferred to them under "new federalism."

Conclusion

It behooves Congress to recognize and oppose the strong negative impact which the elimination of deductibility would have. When the consequences discussed above are seriously considered, it becomes clear why a recent publication by the National Association of Counties concluded that the loss of deductibility "would wreak havoc on state and local governments."

Respectfully submitted,

M. Carl Holman, President
National Urban Coalition

Jacqueline K. Levine, Chair
National Jewish Community
Relations Advisory Council

Naomi Levine
Jerome J. Shestack
Co-Chairs
American Jewish Congress
Commission on National Affairs

Technical Consultant:
Martin Hochbaum, Ph.D.
American Jewish Congress

Statement of the
American Library Association
to the
Senate Committee on Finance
on
Proposed Elimination of the
Deductibility of State and Local Taxes
From Individual Federal Income Tax Liability

July 29, 1985

The American Library Association, a nonprofit educational organization of over 41,000 librarians, trustees, educators, information specialists and other friends of libraries, opposes the proposed repeal of the deductibility of state and local taxes as harmful to library service nationwide and contrary to public policy.

Library service, now provided through elementary and secondary schools, academic institutions, and public libraries in communities all across the country, would suffer if Congress were to repeal the state and local tax deduction from individual taxable income as the Reagan Administration advocates.

The reason libraries are jeopardized by the Administration's proposal is simple: libraries are funded primarily from local and state tax revenues. Residents of rural areas, towns and cities, counties and urban centers in all the states have been willing to tax themselves to create and maintain library service for the whole community, both for the general public and for students of all ages and educational levels. For more than a century, the taxes each citizen paid to fund such public service have been deductible from his or her taxable income at the federal level.

Neither higher mathematics nor divination is required to make the connection between loss of this deductibility at the federal level and provision of tax-supported services at the local and state levels. The financial burden of local and state taxation on the individual taxpayer increases as the offsetting deduction from federal tax liability disappears. Taxpayer revolt, tighter caps on state and local spending, and curtailment of public services are common means to alleviate such financial pressure, and "trimming" the library budget -- a euphemism for substantial cutbacks and elimination of library services and jobs -- are predictable results.

The Congressional Research Service estimates that for every $1.00 of revenue that would be generated by repeal of this deduction, state and local governments would be forced to cut their budgets by 47¢, because taxpayers would demand that about half the tax increase resulting from a loss of SALT-D be offset by lowering state and local taxes. Education receives 94 percent of its funding from states and localities and would bear 42 percent of the $39 billion loss. Local and state taxes account for 87 percent of public library funding.

All fifty states have laws allowing localities to levy taxes to create and provide ongoing support for public library service. The Reagan Administration suggests that allowing state and local tax deductibility for this purpose unfairly subsidizes taxpayers who have elected to provide themselves with such voluntary services. The Administration goes even further, opining that private enterprise might do the job instead and hence the tax deduction inefficiently subsidizes public delivery of services as well.

Federal funding of local libraries -- about four percent of public library funding nationwide according to the National Center for Education Statistics -- has been repeatedly targeted for elimination since the Reagan Administration first took office. The Administration's recent proposed elimination of historic postal subsidies for the mailing of library books and other educational materials would further erode the library's financial base, as would the proposed elimination of general revenue sharing. And now the Administration proposes jeopardizing state and local library funding also -- a threat of grave proportions in light of the fact that 79 percent of public library support comes from local sources, with eight percent from the states.

To suggest that the individual taxpayers who agree to tax themselves for provision of library service to the community are personally enriched unfairly by the deductibility of state and local taxes is myopic to the point of blindness. This Administration overlooks entirely the public benefit that results from taxation for library purposes -- namely the provision of library service to the whole community. A democratic society depends for its survival upon the informed participation of its people. In many communities, the public library is the single cultural institution available to all people without regard to age, social condition or educational attainment. The proposed repeal of state and local tax deductibility thus raises a much broader and more profound issue than erosion of library funding. Public as opposed to private delivery of library and information services is a matter of fundamental public policy.

The Reagan Administration has emphasized what it calls the "privatization" of government information, that is, a shifting of responsibility for collection of government information and its dissemination to the public from the federal government to private sector entrepreneurs. In line with this policy shift, for example, the Merit Systems Protection Board has announced that it will no longer publish the full texts of its decisions in bound volumes. Until now, this information has been published by the federal government, made available to the public through designated depository libraries across the country, and sold through the Government Printing Office at a cost of approximately $55 per year. With elimination of this government publishing program, private publishers are offering the decisions at prices ranging from $250 to $498 per year, not all of which include complete texts. Libraries, reeling from cutbacks of federal funding and now threatened curtailment of local and state funding as well in the name of federal tax reform, are in no position to absorb the steeply increased price structure of government information. The American public is thus quietly losing access to information. Ending the state and local tax deduction would accelerate this trend with the further erosion of library funding.

In short, the Reagan Administration's proposal to repeal deductibility of state and local taxes is contrary to public policy and must be opposed. It would squeeze library funding at local and state levels, resulting in reduction and/or elimination of both services and jobs. But more ominous still is the justification for this proposal: that (1) residents of communities with tax-supported services are receiving an unjust federal subsidy in the form of an individual income tax deduction and (2) if elimination of this deduction causes reduced public service, communities may do without or the service may be provided instead by private enterprise. American Library Association Past President E.J. Josey, of the New York State Library, has repeatedly expressed the Association's concern on this point:

> Nobody would deny the utility of many of these services provided by the private sector, but they are not available to all of the American people; their purpose is to yield a profit, and they are designed only for those who can pay for them. Nor do they have any obligation to provide access to all or any information, only that information which suppliers deem profitable or potentially so. Only the preservation of public services, publicly supported, can assure that each individual has equal and ready access to information, whether provision of that information to that individual is economic (i.e., profitable in private sector terms) or not. (emphasis added)

It is a truism that what private enterprise provides is available to those who can afford to pay and those who can't, do without, unless local, state or federal government intervenes to mandate or itself provide service for all irrespective of ability to pay. There is no question that many upper income Americans can afford to buy whatever library services they and their families require or desire and that most middle and lower income households cannot. Nor is there doubt that our country's history demonstrates a growing national commitment to a system of values that emphasizes the opportunity for all members of society, irrespective of their incomes, to acquire and update knowledge and skills, and to stretch their minds to full capacity. The proposed repeal of state and local tax deductibility flies in the face of the nation's most fundamental democratic values and should not be enacted into law.

Attached to our statement is a resolution passed by the ALA Council on July 10, 1985, expressing our grave concern over this issue. We urge the Committee's favorable consideration of our views, and appreciate the opportunity to present them.

RESOLUTION ON SALT-D

WHEREAS, The Administration's proposed elimination of state-local tax deductibility from federal income taxes is a matter which may well have adverse effects on the provision of local educational efforts; and

WHEREAS, Preliminary estimates have been made showing that state and local governments would lose $39 billion in FY 1987 if deductibility is disallowed; and

WHEREAS, Colleges and elementary and secondary schools would bear 42 per cent of this loss; and

WHEREAS, 87 per cent of the funds supporting community public libraries is derived entirely from state/local levels of taxation; and

WHEREAS, The Administration's budgetary rationale for the zero funding of library programs is based on the premise that state and local governments are in a better position to assume responsibility for basic library services; and

WHEREAS, The lack of tax deductibility from Federal income taxes can only exacerbate the already troubled financial situation of countless American libraries; now, therefore, be it

RESOLVED, That the American Library Association call on all members of the U.S. Congress to examine this proposed measure in light of its effect on American libraries and education.

Adopted by the Council of the
American Library Association
Chicago, Illinois
July 10, 1985
(Council Document #47)

APA
American Planning Association
1776 Massachusetts Ave. NW
Washington, DC 20036
Phone 202 872 0611

August 7, 1985

TO: Chairman and Ranking Minority Member of the:
Senate Committee on Banking, Housing and Urban Affairs
Senate Committee on the Budget
Senate Housing and Urban Affairs Subcommittee
Senate Committee on Energy and Natural Resources
Senate Public Lands, Reserved Water and Resource Conservation Subcommittee
Senate Committee on Environment and Public Works
Senate Regional and Community Development Subcommittee
Senate Committee on Finance
Senate Committee on Governmental Affairs
House Committee on Banking, Finance and Urban Affairs
House Housing and Community Development Subcommittee
House Committee on the Budget
House Committee on Government Operations
House Employment and Housing Subcommittee
House Committee on Interior and Insular Affairs
House National Parks and Recreation Subcommittee
House Committee on Public Works and Transportation
House Economic Development Subcommittee
House Committee on Ways and Means

FROM: Frank Popper, Chairperson, National Policy Coordinating Committee
Melvin R. Levin, AICP, Vice-Chairperson, National Policy Coordinating Committee

RE: POSITION OF THE AMERICAN PLANNING ASSOCIATION ON TAX REFORM

The American Planning Association and our 21,000 members--public officials, planning practitioners at all levels of government, and concerned citizens--share a commitment to the use of sound planning as a necessary ingredient in deciding how to develop, conserve and enjoy our communities and resources.

The American Planning Association is aware of the desirability of simplifying the Federal tax code. In general, we support those proposals which will result in higher taxes paid by corporations and by individuals in the highest income brackets. We understand that the President's tax reform proposals are intended to be revenue neutral, and that the net result should not be losses to state and local governments. Many of our members, however, are employed by state and local agencies. In those capacities they are involved in the delivery and the financing of public services. Planners are aware of the benefits government provides to all citizens, especially to those of low and moderate income. As such, we are concerned about the impact of the following proposals.

I. Deductibility of State and Local Taxes

A. APA opposes the elimination of the deductibility of state and local taxes on several grounds:

1. Deductibility has been a part of the Federal income tax system since it was instituted in 1913. Without this provision it is doubtful that state and local income taxes would have been instituted or would be as widespread as they are.

2. Without deductibility, individuals will be subject to Federal tax on earnings not retained by them, but paid to state and local governments.

3. Elimination of deductibility will affect middle-income taxpayers. 51% of tax returns using this deduction are for incomes less than $30,000. 87% are for incomes less than $50,000.

4. Elimination of deductibility may make state and local governments harder pressed to increase revenues at the same time that cuts in Federal support require them to be the prime providers of domestic services.

5. Elimination of deductibility may result in greater concentrations of poor and elderly people in high tax areas like older inner cities, exacerbating their problems of service provision and budget balancing. More affluent taxpayers can choose to live in lower tax suburban areas if they can no longer deduct high urban property taxes.

6. Elimination of deductibility may encourage state and local governments to raise revenues through less progressive sources such as user fees and other local taxes.

7. Elimination of deductibility may result in pressure to reduce social programs benefiting the neediest people (women and children, especially single parent families).

B. Alternatives to the elimination of deductibility are as follows:

1. Change the deduction to a tax credit; balance the revenue lost through maintaining this exception by continuing to tax individuals in the top income brackets at the existing 50% rate, rather than at the proposed 35% rate.

2. Place a ceiling on the amount of state and local income taxes deducted by individuals in the highest

brackets. For example, permit the deduction of only the amount of tax in excess of the amount of interest earned on nontaxable state and local bonds.

C. In summary, the APA believes that maintenance of the deductibility of state and local taxes is essential to maintain equity among taxpayers and among different areas of the country.

II. Tax Exempt Status of Municipal Bonds

A. The APA opposes terminating the tax exempt status of any municipal bond if more than one percent of its proceeds directly or indirectly benefit any person other than a state or local government, on the following grounds:

1. Many municipally owned facilities are operated by private management. Such facilities as airports, solid waste disposal sites, hospitals, and zoos may result in more than one percent of bond proceeds benefiting the private sector. But a clear majority of the investment benefits the general public.

2. State and local governments rely on tax exempt municipal bonds to finance such public facilities as water plants, mass transit systems, ports, and parking garages. Such financing is endangered by an excessively narrow definition of public purpose.

3. As cities have tried to cope with increases in operating deficits during the 1980's, they have found tax exempt industrial development bonds to be a good way to encourage industrial expansion, thereby strengthening their economic base.

B. Ways to ensure that tax exempt bonds are used for public purposes include requiring that:

1. The facility be publicly owned; or

2. The state or local government issuing the bond retain supervisory or operational control over the facility constructed with the bond; or

3. The state or local issuer make fur assets available to secure payment of a significant service on the bonds.

C. In summary, the APA supports continued tax exemption for municipal bonds which will be used to construct facilities which will be operated for the benefit of the general public.

III. Tax Provisions Relating to the Construction of Low Income Multifamily Rental Housing

A. The APA opposes the elimination of several provisions in the tax code which currently offer incentives to private developers to construct housing that can be rented at below market rates. These provisions include the following:

   1. Multifamily housing bonds
   2. Accelerated depreciation for rental housing under ACRS
   3. Investment tax credits
   4. Syndication benefits

B. The existence of these provisions, and, in particular, tax exempt mortgage subsidy bonds and special purpose industrial development bonds, has made possible accomplishments like those of the Ohio Housing Finance Agency, which was established in 1983, namely:

   1. Creation of 4,500 construction jobs and 500 permanent jobs
   2. Assistance to over 13,000 first-time homebuyers
   3. Low interest mortgage loans to over 4,000 homebuyers in target areas, resulting in the revitalization of depressed neighborhoods
   4. Development of over 2,000 units of housing for the elderly

C. The APA believes that the provision of housing for low and moderate income people is a legitimate governmental purpose. Most direct federal subsidies for such housing construction have been reduced or eliminated. This has made indirect subsidies through the tax code more important than ever. In addition, state governments have had to assume more responsibility for the provision of housing under the new federalism.

   One way states have responded has been to use their constitutionally guaranteed right to issue tax exempt bonds to form public-private partnerships to construct new housing. States have also created housing finance agencies to monitor the administration and operation of such partnerships.

Without tax exempt housing bonds, states will be hard pressed to finance the construction of housing for low and moderate income people. In 1984 there were 7.5 million renter households below poverty level nationwide. Of these 23% or approximately 1.7 million were in subsidized housing. The remaining 5.8 million households are in need of assistance.

IV. Historic Preservation

A. The APA opposes the elimination of the Historic Preservation Tax Credit. This provision of the Economic Recovery Tax Act of 1981 has resulted in the following accomplishments nationwide:

1. $5 billion dollars of private investment has been made in more than 6,800 historic buildings.

2. These projects have been on a small, entrepreneurial scale. On 62% of the residential projects the investment has been less than $150,000. On 80% of the commercial projects it has been less than $1 million.

3. Older areas of the U.S. have enjoyed economic revitalization, as follows:

    a. Local economies have experienced a $4 billion increase in wages.

    b. An estimated 180,500 people have been put to work.

    c. More than $5.3 billion of local retail sales and business activity has been generated.

4. Since January 1982, more than 36,000 housing units have been rehabilitated. Of these, more than 18,500 rental housing units were created by converting underutilized and often abandoned commercial, educational and industrial buildings.

B. In summary, the APA believes that the historic preservation tax credit provides assistance to older urban areas struggling to achieve economic revitalization. It also encourages the preservation of irreplaceable historic buildings, which provides us with such long-term benefits as community pride, shared history, and enhanced quality of life.

Association of American Publishers, Inc.

2005 Massachusetts Avenue, N.W.
Washington, D.C. 20036
Telephone 202 232-3335

Townsend Hoopes
President

June 26, 1985

The Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The Association of American Publishers (AAP) is the principal spokesman for the American book publishing industry. Our members account for approximately 85 percent of all books published, including school and college textbooks. They also produce a range of educational materials including classroom periodicals, maps, globes, films and film strips.

At a meeting on June 13, the AAP Board of Directors expressed deepest concern over the proposal in the Reagan Administration's tax reform plan to eliminate the deductibility of state and local taxes, believing this provision will have a profoundly destructive effect on the public school system in every state across the country.

The negative impact will not be confined to a few "high tax" states, but will be nationwide in scope.

Of the $35-$40 billion which will be lost to the states and local jurisdictions, education will lose approximately $16.3 billion. Such a loss would devastate every state and district school budget, creating an immediate need to raise local property taxes very substantially in order to avoid a progressive drop in already precarious educational standards. In some cases, property taxes may be raised, forcing local citizens into a situation of "double taxation" for the first time in our nation's history; in other cases, proposed property tax increases will be defeated by irate citizens and the quality of local schools will suffer.

As is known, Federal aid to education accounts for only about 6% of the total cost. State aid averages about 40%. This means that more than 50% of the financial support for the public school system, nationwide, depends on local taxes; in large areas of the country - especially New England, the Middle Atlantic States and the Great Lakes regions - the figure is even higher.

As publishers of elementary, secondary and college textbooks, the members of this Association foresee drastic reductions in the purchase of textbooks and all other educational materials, if the state and local deductibility provision is eliminated. Even where local townships are willing to raise their property taxes to sustain present educational levels, the downward pressure on textbook purchases will be severe, for other educational costs - especially teachers' salaries and physical plant maintenance - will absorb the available funds.

In these circumstances, many textbook publishers will suffer a serious deterioration of their market; in a larger sense the quality of our educational system will suffer yet another grave setback.

Given the known, severe stresses in the national educational system and the burgeoning problem of illiteracy, we believe it would be the height of irresponsibility for Congress to eliminate a feature of the present tax system that provides the fundamental prop for education in the United States. If the states and localities are forced to cut their own budgets by passage of this aspect of the Reagan tax reform plan, then the commitment to adequate support levels for education seems certain to be one of the first casualties.

We urge the Finance Committee to oppose this proposal that threatens to eviscerate support for public education.

Sincerely,

Townsend Hoopes
Townsend Hoopes

STATEMENT OF
THE COUNCIL OF STATE HOUSING AGENCIES

SUBMITTED FOR THE RECORD OF

THE SENATE FINANCE COMMITTEE
HEARING ON THE IMPACT OF TAX REFORM
ON STATE AND LOCAL GOVERNMENTS

BACKGROUND

THE COUNCIL OF STATE HOUSING AGENCIES, FORMED IN 1974, REPRESENTS THE COMBINED INTERESTS OF THE HOUSING FINANCE AGENCIES OF 49 STATES, THE VIRGIN ISLANDS, PUERTO RICO AND THE DISTRICT OF COLUMBIA.

ALTHOUGH EACH AGENCY IS CHARGED WITH SEPARATE SPECIFIC RESPONSIBILITIES BY ITS STATE GOVERNMENT, A COMMON BOND IS OUR COMMITMENT TO THE FORMATION OF PUBLIC SECTOR/PRIVATE SECTOR PARTNERSHIPS THAT PROVIDE ADEQUATE AFFORDABLE HOUSING TO LOW- AND MODERATE-INCOME AMERICANS. FURTHER, OUR AGENCIES MONITOR AND MAINTAIN THESE PROJECTS TO ENSURE THAT THIS IMPORTANT PUBLIC PURPOSE OBJECTIVE IS CARRIED OUT THROUGHOUT OUR INVOLVEMENT IN THEM.

SINCE THE PASSAGE OF THE HOUSING ACT IN 1949, AMERICA HAS ACKNOWLEDGED A NEED FOR FEDERAL ASSISTANCE IN THE NATIONAL EFFORT TO SHELTER OUR CITIZENS. EVER SINCE THAT TIME HOUSING

HAS HAD A HIGH PRIORITY IN ALL PUBLIC PURPOSE DISCUSSIONS. THROUGH THEIR INNOVATIVE USAGE OF INDIRECT SUBSIDIES, FEDERAL PROGRAMS, AND THE PRIVATE SECTOR, STATE HOUSING FINANCE AGENCIES HAVE PLAYED A LEADING ROLE IN THIS STRUGGLE, HELPING TO EASE THE ADMINISTRATIVE BURDEN OF THE FEDERAL GOVERNMENT. WE STAND WILLING TO ACCEPT THE PRESIDENT'S CALL FOR AN EVEN GREATER STATE ROLE IN HOUSING, BUT ASK THAT THE TAX REFORM MOVEMENT NOT REMOVE OUR ABILITY TO USE TAX-EXEMPT FINANCING AS A TOOL FOR CAPITAL FORMATION.

NO ONE QUESTIONS THE DESIRABILITY OF A FAIRER MORE EQUITABLE TAX STRUCTURE. CSHA JOINS THE GENERAL PUBLIC IN APPLAUDING THIS GOAL. HOWEVER, WE ARE CONVINCED THAT AS PRESENTLY PROPOSED, TAX REFORM WOULD HAVE TWO DIRE CONSEQUENCES. FIRST, THE ELIMINATION OF TAX-EXEMPT BONDS FOR HOUSING WOULD ALTER THE RELATIONSHIP BETWEEN FEDERAL AND STATE AND LOCAL GOVERNMENTS. SECONDLY, WE ARE COMPELLED TO POINT OUT THE INSEPARABLE INTERPLAY BETWEEN THE TAX CODE AND THE ECONOMY. PRECEDING HEARINGS HAVE POINTED OUT THE DEPTH OF THIS RELATIONSHIP IN MANY INDUSTRIES; AND IT IS EVEN DEEPER WITH RESPECT TO HOUSING. WE URGE THE COMMITTEE TO PROCEED WITH CAUTION AS IT MOVES TOWARD TAX CODE CHANGES THAT WILL HAVE SUBSTANTIAL IMPACT ON HOUSING AMERICA'S LOW- AND MODERATE-INCOME CITIZENS.

THE ECONOMICS OF TAX REFORM

THE FEDERAL DEFICIT IS THE MAJOR PROBLEM FACING THE AMERICAN ECONOMY. SEEKING A SOLUTION TO IT SHOULD BE OUR NUMBER ONE PRIORITY. AS IT RELATES TO TAX REFORM, THE DEFICIT FORCES REVENUE NEUTRALITY TO THE FOREFRONT. ALL CONCERNED AGREE THAT THE IMPLEMENTATION OF TAX REFORM MUST NOT IMPACT FEDERAL REVENUES. HOWEVER, A RECENTLY CONCLUDED STUDY DONE JOINTLY BY WILLIAM APGAR AND JAMES BROWN OF HARVARD AND ARTHUR DOUD AND GEORGE SCHENK OF WHARTON ECONOMETRICS (STUDY) ESTIMATES THAT THE PRESIDENT'S PLAN WOULD INCREASE THE NATIONAL DEBT BY $53 BILLION IN THE PERIOD FROM 1986-1990 AND BY $14.9 BILLION PER YEAR THEREAFTER. I HAVE HERE A COPY OF THE STUDY WHICH I ASK BE MADE A PART OF THE RECORD. MR. CHAIRMAN, I WOULD LIKE TO POINT OUT THAT $50 BILLION IS ALL THAT THE HARD FOUGHT DEFICIT REDUCTION ACT OF 1984 LOPPED FROM THE DEFICIT AND IS CLOSE TO THE DESIRED NUMBER THAT HAS STALLED YOUR COLLEAGUES ON THE BUDGET CONFERENCE FOR THE PAST SEVERAL MONTHS.

THE STUDY'S AUTHORS FURTHER ARGUE THAT ALTHOUGH THERE WILL BE DOWNWARD PRESSURE ON INTEREST RATES, THE INCREASED FEDERAL DEFICIT, AND OTHER PRESSURES, WILL RESULT IN INTEREST RATES GOING SLIGHTLY HIGHER (FIGURE 1).

FIGURE 1

INTEREST RATES UP FROM BASELINE

THE STUDY ALSO SHOWS HOW THE HIGHER BUSINESS TAXES PROPOSED BY THE PRESIDENT WHICH, COMBINED WITH INCREASES IN INTEREST RATES, WILL RAISE THE COST OF CAPITAL AND RESULT IN DRASTIC FALLS IN INVESTMENT. THE RIPPLE EFFECT FROM THESE PHENOMENA WILL ULTIMATELY CAUSE A LOSS OF 215,000 CONSTRUCTION RELATED JOBS (BY 1994) AND, IN THE SAME PERIOD, A DECLINE IN ALL HOUSING UNITS -- BOTH SINGLE AND MULTIFAMILY -- OF AROUND 1,880,000 UNITS. (FIGURES 2-5)

THE RELATIONSHIP OF THE REAL ESTATE/HOUSING/CONSTRUCTION INDUSTRY TO THE OVERALL ECONOMY IS WELL DOCUMENTED. THE STUDY CONCLUDES THAT A LOSS IN REAL PERSONAL INCOME OF $45 BILLION WILL OCCUR BY 1994.

IMPLEMENTATION OF THE PRESIDENT'S PROPOSAL WILL CREATE AN ECONOMIC CATCH-22. THE PUBLIC WILL NEED AFFORDABLE HOUSING MORE THAN EVER IF IT IS ENACTED, YET ITS VERY ENACTMENT WILL INHIBIT THE HOUSING MARKET, AND REMOVE HOUSING INCENTIVES FROM THE TAX CODE.

TAX POLICY AND TAX REFORM

AT THE HEART OF THE TAX REFORM DEBATE LIES THE POLICY QUESTION OF WHETHER OR NOT THE TAX CODE SHOULD BE USED TO PROMOTE CERTAIN SOCIAL GOALS, OR SIMPLY AS A MEANS TO RAISE FEDERAL REVENUES. THE PRESIDENT SEEMS TO HAVE ACKNOWLEDGED THE TAX CODE'S VALUE AS A TOOL FOR SOCIAL POLICY BY RETAINING SOME INCENTIVES FOR INVESTMENT. NOTABLY, THE PROPOSAL WOULD RETAIN PROVISIONS PROMOTING THE ENERGY AND HI-TECH INDUSTRIES.

THE PRESIDENT HAS ALSO ACKNOWLEDGED THE SOCIAL VALUE OF HOMEOWNERSHIP BY ELECTING TO RETAIN THE HOME MORTGAGE INTEREST DEDUCTION. WE APPLAUD THIS DECISION, BUT WOULD ARGUE THAT THE RETENTION OF THIS DEDUCTION AS THE ONLY HOUSING INCENTIVE IS INADEQUATE. A COMMITMENT TO HOUSING AMERICA MUST GO BEYOND THE MORTGAGE INTEREST DEDUCTION. THERE MUST BE PROGRAMS WHICH MAKE HOMEOWNERSHIP MORE EASILY ACHIEVABLE AND PROGRAMS TO MAINTAIN AND INCREASE OUR STOCK OF RENTAL HOUSING. FULLY 35 PERCENT OF AMERICA'S HOUSEHOLDS ARE RENTERS. SURELY THE PRESIDENT DOES

NOT MEAN TO IGNORE THIS SEGMENT OF OUR POPULATION WHEN HE SETS HOUSING POLICY. AS LONG AS THERE IS A NEED FOR HOUSING -- BOTH RENTAL AND OWNERSHIP INVENTORY -- THE FEDERAL GOVERNMENT NEEDS TO PROVIDE INCENTIVES FOR IT. HOUSING SHOULD BE AS HIGH A NATIONAL PRIORITY AS HI-TECH AND ENERGY.

"PUBLIC PURPOSE" AND HOUSING

THE PRESIDENT'S TAX REFORM PROPOSAL HAS RAISED THE ISSUE OF PUBLIC PURPOSE IN THE CONTEXT OF TAX-EXEMPT FINANCING. THE ADMINISTRATION HOPES TO REPEAL TAX-EXEMPT FINANCING EXCEPT FOR THOSE PROJECTS WHICH MEET ITS EXTREMELY LIMITED PUBLIC PURPOSE DEFINITION. THE PLAN CALLS FOR THE REPEAL OF TAX-EXEMPT STATUS FOR ANY BONDS WHERE MORE THAN ONE PERCENT OF THE PROCEEDS ARE USED BY NONGOVERNMENTAL ORGANIZATIONS. UNDER THIS DEFINITION OF PUBLIC PURPOSE, TAX EXEMPTION FOR HOUSING BONDS WOULD BE ELIMINATED.

WE ARE DISTRESSED THAT THE PRESIDENT WOULD ENDORSE A PLAN THAT COMPLETELY IGNORES ALMOST FORTY YEARS OF POLICY. THIS NATION HAS LONG CONSIDERED HOUSING A LEGITIMATE ROLE FOR GOVERNMENT. THE PRESIDENT HIMSELF HAS CALLED FOR AN INCREASED ROLE FOR STATE GOVERNMENTS. STATE GOVERNMENTS, THROUGH THE STATE HFAS ARE MEETING THAT ROLE, AND TAX-EXEMPT BONDS ARE THE CRITIAL FACTOR IN THEIR SUCCESS.

A DEFINITION OF PUBLIC PURPOSE CANNOT BE BASED ON SOME ARBITRARY PERCENTAGE OF USE, OR ON OWNERSHIP OF A PROJECT. THE DEFINITION OF PUBLIC PURPOSE SHOULD BE BASED UPON THE ULTIMATE SOCIAL AND ECONOMIC BENEFTS. SHELTER IS ONE OF THE BASIC NECESSITIES FOR ANY OF US. WHEN COUPLED WITH SERVING LOW- AND MODERATE-INCOME PERSONS, AS OUR PROGRAMS DO, PUBLIC PURPOSE IN OUR MINDS IS A FAIT ACCOMPLI. IN ADDITION, THE SECONDARY EFFECTS INCLUDING NEIGHBORHOOD REVITALIZATION AND THE COMMENSURATE IMPROVED QUALITY OF LIFE REPRESENT MAJOR SOCIAL CONTRIBUTIONS. LASTLY, IN CHRONICALLY CREDIT-SCARCE MARKETS, THE SUPPLY OF CAPITAL CREATED THROUGH TAX-EXEMPT FINANCING ASSURES MORTGAGE AVAILABILITY ON A TARGETED BASIS. FUNDAMENTALLY, THE PROJECTS BUILT AND HOMES FINANCED BY STATE HFAS SERVE THEIR LOW- AND MODERATE-INCOME CITIZENS WELL.

THE FEDERAL GOVERNMENT'S CALL FOR INCREASED STATE ACTIVITY IN HOUSING HAS BEEN WELL RECEIVED; AND WE CAN DO MORE. BY RELYING ON OUR CONSTITUTIONAL RIGHT TO ISSUE TAX-EXEMPT BONDS, AND PRIORITIZING PROGRAMS TO MEET OUR INDIVIDUAL AND LOCAL NEEDS, STATE GOVERNMENTS AND THEIR HOUSING AGENCIES CAN CONTINUE TO PLAY AN IMPORTANT PART IN MEETING OUR NATION'S HOUSING NEEDS.

THE NEED FOR HOUSING

ALTHOUGH THE UNITED STATES IS THE BEST HOUSED NATION IN HISTORY, THERE IS A CONTINUED NEED FOR AFFORDABLE HOUSING.

THIS IS TRUE FOR BOTH RENTERS AND FIRST TIME HOMEBUYERS.

TRADITIONALLY, 25 PERCENT OF INCOME WAS CONSIDERED THE BENCHMARK FOR MEASURING HOUSING AFFORDABILITY. DEPARTMENT OF COMMERCE STATISTICS SHOW THAT MEDIAN RENT AS A PERCENT OF INCOME ROSE FROM 22 TO 29 PERCENT IN THE PERIOD FROM 1973 TO 1983. IN 1983 HUD REPORTED THAT 9.8 MILLION HOUSEHOLDS PAID MORE THAN 30 PERCENT OF THEIR INCOME FOR RENT. THE 1983 ANNUAL HOUSING SURVEY ALSO SHOWED THAT THE MEDIAN RENTER HOUSEHOLD INCOME WAS APPROXIMATELY $13,400. THE CONTINUING NEED FOR PROGRAMS TO MAINTAIN OR LOWER RENTS IS OBVIOUS. A RECENT STUDY BY THE NATIONAL ASSOCIATION OF HOME BUILDERS ATTRIBUTES A 17 PERCENT INCREASE IN RENT SOLELY TO THE ELIMINATION OF TAX EXEMPTION FOR MULTIFAMILY IDBS.

HOMEOWNERSHIP HAS ALWAYS BEEN CONSIDERED THE ULTIMATE AMERICAN DREAM. IT IS A WIDELY KNOWN FACT THAT HOMEOWNERSHIP HELPS CREATE SOLID CITIZENS AND BETTER COMMUNITIES. CONGRESS HAS ALWAYS HELD THE PROMOTION OF HOMEOWNERSHIP TO BE A VALID GOAL OF THE FEDERAL GOVERNMENT. DURING THE LAST CONGRESS MORE THAN TWO THIRDS OF THE MEMBERS OF THE HOUSE SPONSORED THE EXTENSION OF THE MORTGAGE REVENUE BOND PROGRAM. THIS COMMITTEE FAVORABLY REPORTED OUT THAT EXTENSION WHICH WAS OVERWHELMINGLY ADOPTED AND PASSED INTO LAW. HELPING LOW- AND MODERATE-INCOME AMERICANS ACHIEVE THE AMERICAN DREAM OF HOMEOWNERSHIP WAS A VALID USE OF THE TAX CODE LAST YEAR. WE CONTEND THAT IT STILL IS, AND THAT THERE IS STILL A GREAT DEMAND FOR THIS PROGRAM. EVIDENCE OF

THIS EXISTS IN THE FACT THAT SINCE THE REAUTHORIZATION OF THE MRB PROGRAM $12.4 BILLION IN BONDS HAVE BEEN ISSUED (THROUGH DECEMBER 1984), FINANCING MORE THAN A QUARTER OF A MILLION HOMES FOR FIRST TIME HOMEBUYERS.

CREATION OF PUBLIC SECTOR - PRIVATE SECTOR PARTNERSHIPS

GIVEN THE BURGEONING FEDERAL DEFICIT, AND RESULTANT CUTBACKS IN DIRECT FEDERAL SPENDING PROGRAMS FOR HOUSING, THE ROLE OF THE STATES AND THE PRIVATE SECTOR MUST BE INCREASED. UNFORTUNATELY, ONLY A FEW OF THE STATES ARE ABLE TO PROVIDE DIRECT SPENDING OF THEIR OWN. THIS PLACES AN EVEN GREATER BURDEN ON THE PRIVATE SECTOR. STATE HOUSING FINANCE AGENCIES, THROUGH THE USE OF TAX-EXEMPT FINANCING, HAVE HELPED THE PRIVATE SECTOR SHOULDER THAT BURDEN.

IT MUST BE REMEMBERED THOUGH, THAT COMPETITION FOR THE PRIVATE SECTOR INVESTMENT DOLLAR IS FIERCE. INVESTORS ARE FACED WITH A MULTITUDE OF CHOICES RANGING FROM TREASURY BILLS TO THE HI-TECH STOCKS. EVEN WITHIN THE REAL ESTATE/HOUSING INDUSTRY A POTENTIAL INVESTOR IS BOMBARDED WITH POSSIBILITIES. ON AN EQUAL "PLAYING FIELD" ANY OTHER TYPE OF REAL ESTATE, AND MANY NON-REAL ESTATE INVESTMENTS, ARE MORE ATTRACTIVE THAN LOW- AND MODERATE-INCOME HOUSING. IF CURRENT LAW TAX CODE INCENTIVES ARE REMOVED, AS THE PRESIDENT PROPOSES IN HIS TAX REFORM PLAN, PRIVATE SECTOR INVOLVEMENT IN LOW- AND MODERATE-INCOME HOUSING WILL BE ALL BUT

ELIMINATED.

THE IMPACT OF THIS WILL BE SHOWN IN A DRASTIC REDUCTION IN THE CONSTRUCTION OF RENTAL HOUSING. THE STUDY ESTIMATES THAT THE ENACTMENT OF THE PRESIDENT'S TAX PLAN WOULD REDUCE INVESTMENT IN MULTIFAMILY HOUSING BY AN AVERAGE OF 160,000 PER YEAR RESULTING IN A TOTAL DROP IN HOUSING UNITS OF 1,880,000 UNITS BY 1994. STATE AND LOCAL GOVERNMENTS SIMPLY CANNOT AFFORD TO MAKE UP THIS DIFFERENCE ALONE.

THE STUDY ALSO PREDICTS THAT THIS DRASTIC DECREASE IN PARTICIPATION BY THE PRIVATE SECTOR WILL HALT THE PRODUCTION OF 25 TO 30 PERCENT OF ALL RENTAL UNITS CURRENTLY FINANCED BY STATE AND LOCAL HOUSING AGENCIES. THIS WILL EFFECTIVELY REMOVE STATE HOUSING FINANCE AGENCIES FROM THE VALUABLE ROLE THAT THEY PLAY IN PROVIDING HOUSING AND ENSURING THAT THE PROJECTS ARE USED TO HOUSE LOW- AND MODERATE-INCOME HOUSEHOLDS.

MEETING CONGRESSIONAL INTENT IN PROVIDING MULTIFAMILY HOUSING

STATE HOUSING FINANCE AGENCIES ARE PROUD OF THE FACT THAT SINCE 1976 WE HAVE PROVIDED 475,500 UNITS OF RENTAL HOUSING. OF THAT TOTAL 397,700, OR 83.6 PERCENT ARE SPECIFICALLY FOR HOUSEHOLDS WITH INCOMES AT 80 PERCENT OR LESS THAN THE AREA MEDIAN. THROUGH OUR USE OF TAX-EXEMPT FINANCING, RAPID DEPRECIATION AND HUD PROGRAMS, WE HAVE BEEN ABLE TO MEET THE CONGRESSIONAL MANDATE

THAT AT LEAST 20 PERCENT OF A PROJECT HOUSE PERSONS WHOSE INCOME IS 80 PERCENT OR LESS THAN THE AREA MEDIAN. IN MANY INSTANCES OUR STATES GO EVEN FURTHER THAN THE LAW REQUIRES. SOME OF THE SELF-IMPOSED RESTRICTIONS AND TARGETING REQUIREMENTS WHICH OUR STATES UTILIZE INCLUDE:

- INCOME LIMITS FOR MARKET RATE UNITS: THESE STATE HFAS WITH ACTIVE MULTIFAMILY PROGRAMS LIMIT ELIGIBILITY FOR MARKET RATE UNITS TO HOUSEHOLDS WITH INCOMES AT OR BELOW 150 PERCENT OF AREA MEDIAN. THE EFFECT IS TO ENSURE THAT ALL PROJECT UNITS ARE OCCUPIED BY LOW-, MODERATE- AND LOWER MIDDLE-INCOME PERSONS.

- INCOME SET-ASIDES: IN ADDITION TO INCOME CAPS ON MARKET RATE UNITS AND BEYOND THE MANDATORY 20 PERCENT SET-ASIDE FOR LOW-INCOME TENANTS, A NUMBER OF STATE HFAS EXPAND THE AVAILABILITY OF UNITS TO LOW- AND MODERATE-INCOME HOUSEHOLDS, BY INCREASING THE LOW-INCOME SET-ASIDE, E.G. FROM 20 PERCENT TO 30 PERCENT, ADDING SET-ASIDES FOR INCOMES JUST ABOVE 80 PERCENT, E.G. 80 PERCENT TO 100 PERCENT OF MEDIAN, OR IN SOME CASES, LOWERING THE 80 PERCENT OF MEDIAN CEILING FOR THE LOW-INCOME SET-ASIDE, E.G. FROM 80 PERCENT TO 70 PERCENT.

O OTHER REQUIREMENTS/INCENTIVES: A VARIETY OF OTHER MECHANISMS ARE USED BY STATE HFAS TO ASSURE THE AVAILABILITY OF RENTAL UNITS TO LOW- AND MODERATE-INCOME HOUSEHOLDS. THESE INCLUDE FAMILY SIZE INCOME ADJUSTMENTS AND BEDROOM PROPORTIONALITY FOR LOW-INCOME UNITS, APPROVAL OF INITIAL UNIT RENTS AND RENT INCREASES, RENT SKEWING TO LOWER LOW-INCOME UNIT RENTS, AND INCENTIVES TO ENCOURAGE THE CONSTRUCTION OF 3 PLUS BEDROOM UNITS FOR LARGE FAMILIES.

AS ONE CAN WELL IMAGINE, THESE RESTRICTIONS WORK WELL IN SOME STATES, WHILE IN OTHERS WOULD DESTROY A PROJECT'S ECONOMIC VIABILITY. JUST AS THE NOTION OF "PUBLIC PURPOSE" VARIES FROM STATE TO STATE, SO TOO DOES THE VIABILITY OF RESTRICTIONS. CSHA IS CURRENTLY STUDYING EACH OF OUR STATES' PROGRAMS AND THE METHODS EACH USES TO BALANCE THE ECONOMICS OF HOUSING PRODUCTION WITH OUR PUBLIC PURPOSE GOALS. ONCE THIS INTERNAL ANALYSIS IS COMPLETED, AND AN ASSOCIATION-WIDE CONSENSUS IS REACHED, WE LOOK FORWARD TO WORKING WITH THE COMMITTEE TO IMPROVE A SOLID PROGRAM.

IN THE MEANTIME, HOWEVER, WE STAND ON OUR RECORD OF PUBLIC SERVICE, AND INVITE MEMBERS OF CONGRESS, TO VISIT A STATE HOUSING FINANCE AGENCY PROJECT IN THEIR STATE OR DISTRICT. THEY WILL SEE, ALONG WITH THE TRADITIONAL 80/20 PROJECT, HOUSING FOR THE ELDERLY, AND BOTH THE PHYSICALLY AND MENTALLY HANDICAPPED. TAX-EXEMPT FINANCING, COMBINED WITH FLEXIBILITY IN PROGRAM

REGULATIONS, HAS BEEN DIRECTLY RESPONSIBLE FOR ALL OF THESE PROJECTS. THEY WOULD NOT HAVE BEEN BUILT WITHOUT TAX-EXEMPT BONDS.

PROVIDING ASSISTANCE FOR FIRST TIME HOMEBUYERS

THE STUDY FORECASTS THAT THE PRESIDENT'S TAX REFORM PROPOSAL WILL INCREASE THE AFTER TAX COSTS OF HOMEOWNERSHIP APPROXIMATELY 10-12 PERCENT AND REDUCE SINGLE FAMILY CONSTRUCTION BY ABOUT 40,000 UNITS PER YEAR. THIS WILL RESULT IN INCREASING DIFFICULTY FOR YOUNG AMERICANS HOPING TO PURCHASE THEIR FIRST HOME. THE VALUE OF THE MORTGAGE REVENUE BOND PROGRAM CANNOT BE MORE DRAMATICALLY UNDERSCORED. ALONG WITH OUR MULTIFAMILY RENTAL PROGRAMS, STATE HFAS USE TAX-EXEMPT FINANCING TO PROVIDE BELOW MARKET RATE MORTGAGES FOR FIRST TIME HOMEBUYERS. ESPECIALLY USEFUL DURING PERIODS OF HIGH INTEREST RATES, THE MRB PROGRAM HAS RESULTED IN NEARLY ONE MILLION FAMILIES PURCHASING THEIR FIRST HOMES AT MORTGAGE RATES AN AVERAGE OF TWO TO THREE PERCENTAGE POINTS BELOW THE MARKET. THE OVERWHELMING MAJORITY OF THE PARTICIPANTS IN THE MRB PROGRAM WOULD NOT HAVE BEEN ABLE TO PURCHASE THEIR HOMES WERE IT NOT FOR THE PROGRAM.

IRS CODE SECTION 103(A) PROVIDES THAT TAX-EXEMPT MRBS MAY BE USED TO FINANCE ONLY SINGLE FAMILY HOMES THAT:

- O COST NO MORE THAN 110 PERCENT OF THE AVERAGE AREA PURCHASE PRICE (120 PERCENT IN TARGETED AREAS);

- O WILL BE OWNER OCCUPIED;

- O BY A PURCHASER WHO HAS NOT HAD ANY OWNERSHIP INTEREST IN THEIR PRINCIPAL RESIDENCE DURING THE PRIOR 3-YEAR PERIOD (NON-TARGETED AREAS ONLY).

AS WELL TARGETED AS THE MRB PROGRAM IS, MANY OF OUR AGENCIES HAVE IMPOSED FURTHER RESTRICTIONS IN THE FORM OF INCOME ELIGIBILITY REQUIREMENTS, LOWER SALES PRICE MAXIMUMS AND LOAN APPLICATION PRIORITIZATION. OUR SELF-EXAMINATION IS FOCUSING ON MRBS AS WELL AS MULTIFAMILY HOUSING IDBS. ONCE IT IS FINALIZED WE LOOK FORWARD TO SHARING THE RESULTS WITH THIS COMMITTEE. AGAIN THOUGH, WE MUST POINT OUT THE RESURFACING PROBLEM OF CERTAIN RESTRICTIONS WORKING ONLY IN CERTAIN STATES. A DEGREE OF FLEXIBILITY IS NEEDED.

SUMMATION

THE COUNCIL OF STATE HOUSING AGENCIES IS DEDICATED TO THE PUBLIC PURPOSE OF PROVIDING AMERICA'S LOW- AND MODERATE-INCOME CITIZENS WITH ADEQUATE, AFFORDABLE SHELTER. WE ARE CONCERNED THAT THE ENACTMENT OF THE PRESIDENT'S TAX REFORM PLAN WILL RESULT IN SERIOUS A UPHEAVAL IN THE HOUSING/REAL ESTATE/CON-

STRUCTION SEGMENT OF OUR ECONOMY. THIS INDUSTRY HAS LONG BEEN CONSIDERED THE FOUNDATION OF OUR ECONOMY AND DRASTIC DECREASES IN IT WILL GENERATE NEGATIVE EFFECTS THROUGHOUT THE SYSTEM. COMBINED WITH THE FORECAST INCREASE IN THE FEDERAL DEFICIT AND THE NATURAL BUSINESS CYCLE, THE LONG-TERM ECONOMIC OUTLOOK IS CLOUDY.

A DOWNTURN IN THE ECONOMY WILL ADD TO THE ALREADY GREAT DEMAND FOR HOUSING; ESPECIALLY AT THE LOW- AND MODERATE-INCOME LEVELS. SHOULD TAX REFORM BE ENACTED OUR CITIZENS WILL BE PAYING AN ESTIMATED 20-24 PERCENT MORE IN RENTS AND THEY WILL BE PAYING FOR SMALLER, OLDER UNITS. HOMEOWNERSHIP COSTS WILL INCREASE BY 10-12 PERCENT, MAKING IT EVEN HARDER FOR NEW FAMILIES TO VACATE THE RENTAL MARKET. THE RESULT WILL BE INCREASED PRESSURE ON A STALLED INDUSTRY.

ALL OF THIS WILL BE HAPPENING IN AN AMERICA THAT HAS CUT THE MAJORITY OF ITS DIRECT SPENDING HOUSING SUBSIDIES AND WILL HAVE ELIMINATED VIRTUALLY ALL OF ITS TAX CODE RELATED INDIRECT SUBSIDIES. FOR THE FIRST TIME IN 35 YEARS THERE WILL NOT BE A NATIONAL COMMITMENT TO HOUSING AMERICA'S CITIZENS.

YET THIS NEED NOT BE THE SCENARIO. WE URGE CONGRESS TO ACT CAUTIOUSLY AND MODERATE THE PRESIDENT'S PROPOSAL AS IT RELATES TO HOUSING. WE POINT TO THE SUCCESSES THAT TAX-EXEMPT FINANCING HAVE GENERATED. (EACH OF OUR AGENCIES WILL BE FORWARD-

ING DATA TO THEIR MEMBERS OF CONGRESS ON THE PROJECTS IN THEIR STATES AND DISTRICTS.) THE PRESIDENT'S CALL FOR INCREASED STATE INVOLVEMENT IN HOUSING LOW- AND MODERATE-INCOME AMERICANS CAN BE WELL SERVED BY STATE HOUSING FINANCE AGENCIES WORKING IN CONJUNCTION WITH THE PRIVATE SECTOR. MR. CHAIRMAN, WE RESPECTFULLY URGE CONGRESS TO ACKNOWLEDGE OUR EFFORTS BY ALLOWING US TO KEEP OUR MOST EFFECTIVE TOOLS AND ASK THAT WELL TARGETED, EFFICIENT TAX-EXEMPT FINANCING PROGRAMS FOR HOUSING BE RETAINED AS A PART OF ANY REFORMED TAX CODE. WE REITERATE OUR WILLINGNESS TO WORK WITH THE COMMITTEE TOWARD THIS END.

July 25

STATEMENT FOR THE RECORD

on behalf of

THE DELAWARE SCHOOL BOARDS ASSOCIATION

on

TAX REFORM

before the

COMMITTEE ON FINANCE
U.S. Senate

August 7, 1985

The Delaware School Boards Association represents all 19 public school districts in Delaware.

We view with alarm the federal proposal to repeal the deduction for state and local taxes as part of the tax simplification plan.

In Delaware, 41.7% of our taxpayers itemize their federal tax returns. Compared to the nation as a whole, this percentage is relatively high (30 states have a lower percent based on 1984 data from the Office of the Secretary of the Treasury).

Delaware also receives fewer federal dollars back per person than 44 other states ($593 loss per individual based on 1985 data from State Policy Research, Inc.).

As a result in changes to the Delaware Code relative to school finance made in 1984, school districts have the first real incentive to increase their local school tax burden. In the last two years, at least half of these districts have passed significant tax increase by referendum.

The State of Delaware is highly dependent on the personal income tax as a revenue source. In fact the state income tax is the only broad based tax we levy. Coupled with this is the fact that the State funds 71% of the total cost of public education.

Given the above information, it would certainly follow that if state and local tax deductions were disallowed, tremendous public pressure would build to lower these tax rates currently levied. This would not only have an effect on locally raised funds but would adversely effect the state funds available for allocation to public education in Delaware.

The tradition, to date, of the federal government has been to encourage the growth and stability of local and state taxing authorities through use of the tax deduction.

We do not see how breaking this tradition will accomplish anything more then to undermine the entire funding structure that now provides the resources to educate our youth.

The Delaware School Boards Association urges that the repeal of state and local tax deductions not be made part of any tax simplification program. The ramifications and the risks far out weigh any potential advantages.

Free the Eagle
CITIZEN'S LOBBY

HOWARD J. RUFF CHAIRMAN

1985 JUL 30 [illegible]

July 29, 1985
HAND DELIVERED

Honorable Bob Packwood
Senate Committee on Finance
SD-219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Packwood:

It is my understanding that the Senate Committee on Finance will be continuing to hold hearings on tax reform. We, at Free the Eagle, are excited about your concern over this country's taxation practices, and we applaud you for your decision to listen to America's plea for reform.

As Legislative Director of Free the Eagle, I would like to testify at the hearings. As you may know, Free the Eagle Citizen's Lobby deals mainly with preserving economic freedoms, along with supporting other issues of basic importance to the American citizen.

If you would like further information in regard to our proposed testimony, or if you need assistance in getting anyone else to testify at the hearing, please do not hesitate to contact us.

With every best wish, I am

Sincerely,
John C. Houston
John C. Houston
Legislative Director

JCH/rjm

214 Massachusetts Avenue, N.E., Suite 510, Washington, D.C. 20002 (202) 547-2122

TESTIMONY
OF
THE HONORABLE RICARDO J. BORDALLO
GOVERNOR OF GUAM

BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE
CONCERNING CHAPTER 15.05 OF THE
PRESIDENT'S TAX REFORM PROPOSAL

25 JULY 1985

The mirror image tax in Guam has a motley lineage. At the time the Organic Act of Guam was under consideration, the United States income tax laws applied only to the States, the District of Columbia, and the "Territories"; that is Territories with a capital "T". Capital "T" Territories are territories such as Alaska and Hawaii which were incorporated into the United States and to whom statehood had been promised. The legislative history of the Organic Act makes clear that Congress was not prepared to make such a promise to Guam. Nor, as we understand it, is the current Congress prepared to make such a promise. Guam was made an unincorporated territory, was denied statehood and any promise of statehood and was not to be subject to the United States' income tax. The reason for the last provision is clear enough. Under the Organic Act, Guam had no voice electing the President of the United States nor was it represented in the House of Representatives or the Senate of the United States. In later years, Guam was given a non-voting representative in the House of Representatives. Though we very much appreciate the privilege of being able to send a representative to this body, the lack of contitutionally sanctioned representation remains to this day.

In light of this, the Drafters of the original Organic Act wisely chose to treat Guam as a Possession for the United States for tax purposes. This meant that the United States would not tax Guam or Guamanians except to the extent that they derive income from the United States.

That taxes may only be imposed with the consent of elected representatives of the taxpayers is one of the oldest and most fundamental principles in the American tradition. As only one illustration, I would like to read to you a portion of the Virginia Stamp Act resolutions passed May 30, 1765, by the House of Burgesses of Virginia:

> "Resolved that the taxation of the people by themselves, or by persons chosen by themselves to represent them, who can only know what taxes the people are able to bear, or the easiest method of raising them, and must themselves be affected by every tax laid on the people, is the only security against burdensome taxation, and the distinguishing characteristic of British freedom, without which the ancient constitution cannot exist."
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> ***
>
> "Resolved, therefore, that the General Assembly of this Colony have the only and sole exclusive right and power to lay taxes and impositions upon the inhabitants of this Colony, and that every attempt to vest such power in any person or persons whatsoever other than the General Assembly aforesaid has a manifest tendency to destroy British as well as American freedom."
>
> ***
>
> "Resolved that any person who shall, by speaking or writing, assert or maintain that any person or persons other than the General Assembly of this Colony, have any right or power to impose any taxation on the people here, shall be deemed an enemy to His Majesty's Colony."

It is worth stressing that the original Organic Act as proposed was consistent with these traditional American notions and left the power of Guamanian taxation to Guamanians.

However, during the legislative process, Congressman Miller of Nebraska introduced a rider to the Organic Act. In explaining his amendment, he said:

> "The Amendment we have just adopted in Committee provides that the income tax laws in force in the United States of America and which may hereafter be in force will be the law over there. That will be of great help in plugging certain loopholes. The people of Guam and a large number of civilians and workers over there on construction work, as well as military personnel, pay no income tax or have no withholding tax. In fact, they are paid a bonus for working there. This will plug that loophole and bring in some money to the United States Treasury."

Thus, was the Mirror image tax born on Guam. A hastily conceived rider introduced by a Congressman to "plug loopholes" "over there" without considering that only the people who must pay the taxes and their representatives can know what taxes are bearable and the easiest method of raising them. Of course, Congress was primarily concerned with taxing those U.S. citizens temporarily in Guam as employees of the United States Government. They might reasonably be expected to contribute to the United States Treasury. However, the mirror image came to be understood as applying to all Guamanians and all Guam source income.

The difficulties with the mirror image system have been documented many times. One of the best discussions is found in an article by Karla Hoff entitled, "U.S. Federal Tax Policy Towards the Territories: Past, Present and Future" which appeared in the Tax Law Review, Volume 37, No. 1 for 1981. I attach a copy of that article to my testimony for the Committee's reference.

Rather than restate the material in that article, I would point out the single most burdensome aspect of the mirror image to Guam - revenue instability. The Congress is continually changing U.S. tax laws. In the last ten years, major changes occurred in 1976, 1978, 1981, 1982 and 1984, and a further revision is now under consideration. Congressional action dramatically affects Guam revenue. This makes it virtually impossible to do any long-term financial planning. Even when proposals are said to be "revenue neutral" as the ones before you, they are not neutral for Guam. Our per capita income is less than that of any State in the Union. Reforms which reduce the burden on low income taxpayers but provide "compensating revenue" from middle and upper taxpayers erode our tax base since we have a larger proportion of low income taxpayers than on the U.S. mainland.

Also, the complexities of the mirror image system make tax administration on Guam most difficult. Our island contains roughly one hundred ten thousand people. Apart from the Commonwealth of the Northern Marianas, we are thousands of miles from the nearest U.S. tax jurisdiction. It is simply not possible to support a staff with the experience and knowledge of the more specialized portions of the U.S. tax code with such a population base. As a result, we must concentrate on general issues. Income taxed under the more specialized rules will tend to escape taxation.

For all these reasons, we strongly support the President's proposal to eliminate the "mirror image system" and to restore to Guam its rightful power to levy its own taxes. However, I believe that more thought should be given to the transitional provisions.

On October 21, 1976, the United States Congress passed Public Law 94-584 authorizing the people of Guam to organize their government pursuant to a constitution of their own adoption. The Guam Legislature was authorized to call constitutional conventions to draft constitutions for local self-government. While the first constitution proposed in Guam was rejected by the voters, P.L. 94-584 would authorize a second attempt. I understand that a constitution was adopted on the second try in the Virgin Islands.

The people of Guam have concluded that a thorough revision of the exiting Guam-Federal relationship is necessary and for that reason we have deferred pressing for a constitutional convention. However, in light of the somewhat lengthy process that lies ahead for the revision of that relationship and the willingness of Congress to grant certain powers to the people of Guam, I believe that it would be well for Guam to proceed to adopt a constitution, even if that constitution were to be amended in the light of the final Guam Territorial Relationship

Act.

In the interim, we plan to adopt the present code to at least preserve revenue neutrality. I have established a Tax Review Committee representing a good cross-section of the community. Government Officials, business leaders, legal and accounting professionals and other interested individuals form the core of this Committee with my Director of Revenue and Taxation as chairman.

We are confident that the tax system eventually presented to the people of Guam will be fair and consistent with the Territories' economic goals and objectives. We ask that you to favorably consider this important provision of the President's proposal so that Guam can more efficiently develop itself into an economically self-sufficient territory.

Thank you very much for allowing me to present this testimony.

that unlike the rum tax, the gasoline tax was not such an equalization tax.[140]

The court of appeals observed that a literal interpretation of "all taxes . . . on articles produced in Puerto Rico [or the Virgin Islands] and transported to the United States" would require the transfer to these islands of all tax revenues ever collected when an article from the islands later became the subject of a taxable transaction in the United States. Since the administrative problems inherent in such reading were "truly staggering," the court concluded that the phrase "all taxes" was ambiguous and required some form of limitation based on the legislative history of the provision.[141] In the light of that history, the court agreed with the United States that the statutory phrase referred only to taxes imposed on articles produced in the territory and transported to the United States in order to equalize their competitive position in the U.S. market.[142] The phrase did not include the gasoline tax, a tax imposed at the point of sale and as such not a tax which articles from the territories would otherwise escape.[143]

U.S. Income Tax Relationship With Guam

Historical Background

Although the United States acquired Guam from Spain in 1898, Guam was not granted self-government until 1950. In the interim, a succession of naval governors exercised sole responsibility for the administration of the island, pursuant to a two-line executive order of President McKinley.[144] The naval governors received periodic appropriations from Congress. U.S. internal revenue laws were not locally applicable. In 1950, Congress granted a measure of self-government to the people of Guam and made all native Guamanians U.S. citizens.[145] The Organic Act of 1950 provided for a locally elected legislature and a governor appointed by the President.

Once the elected officials of Guam had the right to draw up Guam's

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the U.S. market. Since U.S. internal revenue laws do not, in general, directly apply to Puerto Rico or to the Virgin Islands, U.S. taxes on production do not reach goods produced in the islands. U.S. sales taxes, on the other hand, reach all goods sold within the United States and, thus, sales taxes do not have counterpart equalization taxes.

[140] Brief for Appellant at 1–16 (both cases).

[141] 642 F.2d at 566–626.

[142] 642 F.2d at 632–633.

[143] *Ibid.*

[144] Executive Order No. 108–A (1898).

[145] Organic Act of Guam, ch. 512, § 4(a) 64 Stat. 384 (1950) (8 U.S.C. §§ 601–05).

budget. Congress expected the residents to finance the local government, other than the salaries of federal appointees. During debate on the proposed Organic Act, one congressman stated that there were "sufficient sources of revenue right there on the island of Guam so that they will be able to set up a tax structure sufficient to carry their own expenses of government without asking for any contribution from the United States to help carry their government cost."[146]

In 1950, Guam had a population of 96,000, of whom 26,000 were native Guamanians and most of the remainder were members of the U.S. armed forces or employees of U.S. government contractors. An economic boom was in progress as a result of war reconstruction. Much of the income, however, escaped taxation. The U.S. tax jurisdiction did not extend to citizens of Guam (not otherwise citizens of the United States),[147] or to foreign nationals and foreign corporations deriving income from Guam, since the Code defined the United States to include only the states, the District of Columbia and the territories of Alaska and Hawaii.[148] U.S. citizens and U.S. corporations deriving their income primarily from Guam were likewise exempt from federal income taxation under a provision enacted in 1921 to alleviate the competitive disadvantage of U.S. businessmen relative to foreign businessmen in the Philippines and other U.S. possessions.[149]

To close the "loophole" through which persons in Guam escaped all income tax,[150] Congress provided in a rider to the Organic Act that "[t]he income tax laws in force in the United States of America and those which may hereafter be enacted shall be held to be likewise in force in Guam."[151] Another section of the Organic Act provided that "[a]ll customs duties and Federal income taxes derived from Guam . . . shall be covered into the treasury of Guam."[152]

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[146] 96 CONG. REC. 7577 (1950) (remarks of Rep. Scrivner and Rep. Miller).

[147] Revenue Act of 1918, ch. 78, § 260, 40 Stat. 1087 (1919) (reenacted as section 252 of the Internal Revenue Code of 1939 and, as amended, I.R.C. § 932). See N. 37 *supra.*

[148] *Id.* § 1 (reenacted as section 3797(a)(9) of the Internal Revenue Code of 1939).

[149] Section 252 of the Internal Revenue Code of 1939 (restated as I.R.C. § 931). The exemption currently applies only to U.S. corporations doing business in the possessions under I.R.C. § 936.

[150] 96 CONG. REC. 7577 (1950) (remarks of Rep. Miller).

[151] Organic Act of Guam, ch. 512 § 31, 64 Stat. 392 (1950) (current version at 48 U.S.C. 1421(i) (Supp. 1979)).

[152] *Id.* § 30 (codified in 48 U.S.C. 1421(h) (1976)). This section also provided that U.S. internal revenue taxes on goods produced in Guam and transported to the United States shall be deposited into the treasury of Guam. The amount of taxes covered over pursuant to this section was small in 1950, and today is zero, as no goods entering the United States from Guam are currently subject to a federal manufacturer's excise tax. See VIRGIN ISLANDS REPORT, *supra* N. 71, at 17.

as the, [illegible]

The legislative history of the Organic Act suggests that the payment of federal taxes derived from Guam into the Guamanian treasury was intended to be a temporary measure. Thus, the following statement appears in a 1954 report by the Senate Committee on Interior and Insular Affairs:

> [A]t the time of the hearings on the Organic Act for Guam in 1950 (Public Law 630, 81st Cong.) we were assured by the Governor of Guam, with the acquiescence of the representatives of the Territorial legislature,[153] that if all the taxes either from incomes of persons on Guam or products or activities originating in Guam, were granted to the insular treasury for a period of 2 years, the island could become self-supporting. Those 2 years have become 4 years and, in the pressure of business and activity in the Senate, nothing has been done about determining whether Guam is or is not self-supporting without the prop of revenues which other American citizens have to pay to support their Federal Government.[154]

No determination was made and, in the meantime, controversy arose as to whether the United States or Guam had authority to administer the U.S. income tax laws in force in Guam. Guam had proceeded to collect the U.S. income tax imposed on its residents after 1950, and numerous suits for refund were filed.[155] To ratify the assessments and collections that Guam had made, Congress in 1958 enacted legislation "clarifying" the meaning of section 31 of the Organic Act. Public Law Number 85-688 provided that the U.S. income tax laws as applicable to Guam under section 31 of the Organic Act imposed "a separate Territorial income tax," administered by the government of Guam.[156] In order to obtain a "mirrored effect" between the federal and Guamanian income taxes, Congress provided that "except where it is manifestly otherwise required, the applicable provisions of the Internal Revenue Codes of 1954 and 1939 shall be read so as to substitute 'Guam' for 'United States.' "[157]

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[153] The Congress of Guam dated back to 1917, although it exercised only an advisory role before 1950. H.R. Rep. No. 1677, 81st Cong., 2d Sess. 9 (1950).

[154] Virgin Islands Report, *supra* N. 71, at 18. This statement by the Governor of Guam is also referred to in S. Rep. No. 2109, 81st Cong., 2d Sess. 15 (1950).

[155] *See, e.g.*, Jennings v. United States, 155 F. Supp. 571 (Ct. Cl. 1957); Laguana v. Ansel, 102 F. Supp. 919 (D. Guam 1952), *aff'd per curiam*, 212 F.2d 207 (9th Cir. 1954).

[156] 48 U.S.C. §§ 1421i(b) and (c) (1976).

[157] 48 U.S.C. § 1421i(e) (1976). *See also* H.R. Rep. No. 2273, 85th Cong., 2d Sess. 5–6 (1958).

Status of U.S. Persons Under U.S. Tax Law Applicable in Guam

The result of Public Law Number 85–688 was to establish in Guam an income tax system which incorporated virtually all of the pitfalls of the Virgin Islands income tax. By codifying the language substitution system (which is the basis of the mirror system), it provided that Guam would tax U.S. nationals under U.S. law as though they were foreign persons.[158] In general, the courts upheld the tax consequences that follow from the mirror system.[159]

Beginning in 1968, representatives of the Virgin Islands and Guam met with U.S. representatives to work out a way to remove the anomalies created by the mirror systems. This task force's product—legislation passed in 1972—substantially modified the application of the Guam mirror system to individuals.[160] From the perspective of the individual taxpayer, Guam became a collection district of the United States, identical for most U.S. income tax purposes to a stateside collection district. Under new section 935, a resident of the United States or Guam is required to file only one tax return—with Guam if he is resident there on the last day of the year, or with the United States if he is resident in one of the 50 states or the District of Columbia on the last day of the year.[161] For purposes of computing the individual's tax liability, section 935 provides that domestic source income shall include income derived from sources within either the United States or Guam.[162] In the event that an individual is resident in Guam for only a part of his tax year and resident in the United States for another part of the year, section 935 allows full credit for taxes paid to or withheld by both jurisdictions without regard to the foreign tax credit limitation.[163] Thus, income taxes withheld by one jurisdiction can be claimed as a credit in the jurisdiction where the individual files his return, just as if the taxes had been withheld by the jurisdiction of residence.[164]

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[158] See the text accompanying Ns. 94–95 *supra*.

[159] *See, e.g.*, Sayre & Co. v. Riddell, 395 F.2d 407 (9th Cir. 1968); Government of Guam v. Koster, 362 F.2d 248 (9th Cir. 1966). However, the mirror theory was not applied in Atkins-Kroll (Guam) Ltd. v. Government of Guam, 367 F.2d 127 (9th Cir. 1966), *cert. denied*, 386 U.S. 993 (1967). These cases were later relied upon by the Third Circuit in cases involving the income tax in the Virgin Islands.

[160] Pub. L. No. 92–606, 86 Stat. 1494 (1972). This legislation did not modify the mirror system as it applied to corporations, except with respect to the 30 percent flat tax imposed under I.R.C. § 881 on "domestic" source investment income paid to "foreign" corporations. The legislation added new section 881(b) to the Code to provide that a Guam corporation would not be treated as a foreign corporation for purposes of that section. Mirroring that provision into Guam tax law, section 881(b) provides that a U.S. corporation will not be treated as a foreign corporation for purposes of the Guam tax imposed under section 881. The explanation for this exemption was that Congress wished to promote U.S. investment in Guam. H.R. Rep. No. 92–1479, 92d Cong., 2d Sess. 2–3 (1972).

[161] I.R.C. § 935(b).

[162] I.R.C. § 935(c).

The 1972 legislation preserved Guam's claim, originally in section 30 of the Organic Act of Guam,[165] to the federal income taxes paid by U.S. military employees stationed in Guam. Such individuals are, in general, not taxable directly by Guam.[166] The legislation added new section 7654(d) to the Code, requiring that the Secretary of the Treasury pay to Guam the taxes withheld by the United States with respect to the compensation of military personnel based in Guam—currently somewhat less than $15 million per year.[167]

The 1972 legislation eliminated the perceived inequities and legal uncertainties in the taxation of U.S. citizens subject to income taxation in Guam, but it gave rise to new problems in the division of revenues between the United States and Guam.[168] The legislative history of section 935 suggests that Congress intended to provide Guam the exclusive right to tax full-year residents of Guam.[169] Section 935(c)(3) is categorical: residents of Guam are hereby "relieved of liability" for the United States income tax. However, the 1972 law did not make federal tax withholding obligations consistent with the liability rules set down in section 935(c)(3), nor (as an alternative) did it provide a comprehensive mechanism for the federal government to pay these taxes into the Guamanian treasury. Inconsistencies exist in three areas:[170]

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[163] Reg. § 1.935-1(b)(1).

[164] At the time the Guam bill was enacted, the Joint Committee on Taxation and the Assistant Secretary of the U.S. Treasury expressed the hope that the provisions of the legislation could eventually be extended to cover the United States-Virgin Islands income tax relationship as well. However, the Virgin Islands did not wish to adopt the new scheme because it would have provided that U.S. residents with an unincorporated Virgin Islands business were taxable only by the United States. In addition, the Virgin Islands did not wish to give up the 30 percent withholding tax on direct U.S. investment in the Virgin Islands. A major advantage of the proposal to Guam—elimination of the dual filing requirement for Guam residents with U.S. source income—did not provide any benefit to the Virgin Islands, which had already obtained a single filing rule for its inhabitants under section 28(a) of the Revised Organic Act of the Virgin Islands of 1954 (current version at 48 U.S.C. § 1642 (Supp. 1979)).

[165] Section 30 of the Organic Act of Guam, ch. 512, 64 Stat. 392 (1950), provides, in pertinent part: "Federal income taxes derived from Guam . . . shall be covered into the Treasury of Guam." This provision of section 30 was superseded by I.R.C. §§ 935 and 7654. *See* Reg. § 301.7654-1(a).

[166] The Soldiers and Sailors Civil Relief Act, 50 U.S.C. § 574 (1976) provides, in relevant part: "[A] person shall not be deemed to have lost a residence or domicile in any State, Territory [or] possession . . . solely by reason of being absent therefrom in compliance with military or naval orders, or to have acquired a residence or domicile in any other State, Territory [or] possession . . . while, and solely by reason of being, so absent. For the purposes of taxation in respect of the . . . income or gross income of any such person by any State, Territory [or] possession . . . of which such person is not a resident or in which he is not domiciled, compensation for military or naval service shall not be deemed income for services performed within, or from sources within, such State, Territory [or] possession."

[167] For 1981, the *Appendix to the Budget of the United States Gov't* (fiscal year 1982), at I-M69, reports that Guam received a total of $18.9 million in U.S. income taxes withheld from the compensation of U.S. government *civilian* and *military* employees for services performed in Guam. No breakdown of the amounts is available. For the authority for the payment to Guam of U.S. taxes withheld from the compensation of federal civilian employees in Guam, see the text accompanying Ns. 169-71 *infra*.

> (1) The United States withholds tax on compensation paid to U.S. government employees in Guam. Currently, these withholding taxes are covered over to Guam pursuant to a 1973 Treasury recommendation to the Internal Revenue Service to continue to cover over these withholding taxes as if section 30 of the Organic Act had not been fully superseded.
>
> (2) The United States withholds (and retains) tax on pension payments to retired military and civil service employees resident in Guam.
>
> (3) The United States withholds (and retains) tax on compensation paid to residents of Guam serving in the U.S. armed forces.

In 1980, the legislature of Guam petitioned Congress to end the "inequitable division of tax revenues between the United States and Guam."[171] The U.S. Treasury indicated to the government of Guam that, if necessary, it would be prepared to seek statutory clarification.[172]

Opportunities for Federal Tax Evasion and Avoidance

In addition to the interpretative questions raised by the federal income tax relationships with the Virgin Islands and Guam, these relationships create numerous opportunities for federal tax avoidance and evasion. Such opportunities arise from the fragmentation of tax jurisdiction over U.S. taxpayers and from the failure of particular U.S. tax provisions to take account of the special status of the Virgin Islands and Guam.

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[168] *See* Territorial Income Tax Systems, *supra* N. 7, at 22.

[169] H.R. Rep. No. 92-1479, 92d Cong., 2d Sess. 4 (1972). However, a separate rule was adopted requiring certain high-income individuals to report the respective amounts of their income from Guam and the United States so that the tax collections on such persons could be prorated between the two jurisdictions. I.R.C. § 7654(a); see I.R.C. § 6688.

[170] *See* Territorial Income Tax Systems, *supra* N. 7, at 22.

[171] Res. 433, 15th Guam Legislature (1979).

[172] Territorial Income Tax Systems, *supra* N. 7, at 23.

Under the Virgin Islands mirror system, a U.S. citizen or a U.S. corporation that claims residence in the Virgin Islands can earn U.S. source income without having to pay federal income tax or file a federal income tax return. Under the Guam mirror system, an individual who claims residence also has no obligation to file a U.S. tax return. Although residents of a territory are required to pay tax on their worldwide income under the U.S. income tax laws administered by the territory, individuals have an incentive to make claims to territorial residence because the Virgin Islands and Guam do not have the resources nor, apparently, the political will to enforce the Code.[173] One senior official of the Guamanian tax department recently listed 15 different areas of the tax law, including consolidated returns, corporate distributions and source of income rules, of which no employee of the tax department had any knowledge. The U.S. Treasury has noted this means of evading federal tax and the fact that "the IRS is not well positioned to prevent the evasion of U.S. taxes by individuals with dubious claims to residence in a territory."[174]

An individual who does change residence from the United States to the Virgin Islands or Guam, or vice-versa, may attempt to change accounting methods in order to minimize tax. The tax savings could be substantial where, for example, a cash basis taxpayer has realized a gain on a sale and is reporting the gain on the installment method.[175] After the taxable year of the installment sale, the taxpayer could change his residence from, say, the Virgin Islands to the United States. The installment sale seemingly would insulate the amounts received in subsequent years from Virgin Islands tax provided that the seller, a nonresident alien with respect to the Virgin Islands, does not engage in a trade or business in the Virgin Islands in subsequent years when installment payments are received.[176] Upon filing his first return with the United States, the taxpayer could adopt the accrual method and take the reporting position that all of the gain on the transaction was recognized in the year of sale. Although such a change in accounting methods is presumably contrary to law,[177] the difficulty of discovering the change undermines federal tax administration.

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[173] See letter from Elmer Staats, Comptroller General of the United States, to Representative Morris Udall (Oct. 3, 1979).

[174] TERRITORIAL INCOME TAX SYSTEMS, *supra* N. 7, at 40.

[175] I.R.C. § 453. *See* Berney, *Transfer of Installment Obligations to the U.S. Virgin Islands*, 7 INT'L TAX J. 229 (1981).

[176] Reg. § 1.871–8(c)(1) (as mirrored into the Virgin Islands tax law).

[177] Under section 28(a) of the Revised Organic Act of the Virgin Islands of 1954 (current version at 48 U.S.C. § 1642 (Supp. 1979)), an inhabitant of the Virgin Islands satisfies his income tax obligations to the United States by paying income taxes to the Virgin Islands. Therefore, when he changes his residence from

Federal law requires the Virgin Islands and Guam to collect the tax due under the locally applicable U.S. income tax laws, but generally it does not prohibit the territories from rebating the taxes collected.[178] Tax incentive legislation adopted by the legislatures of the Virgin Islands and Guam allows a rate reduction of up to 100 percent of the otherwise applicable 46 percent rate for qualifying businesses.[179] A corporation which is an "inhabitant of the Virgin Islands" or a "possessions corporation" will avoid paying tax to the United States, as well.[180] A U.S. parent corporation can, in turn, offset a dividend received from a wholly-owned U.S subsidiary in the territory with a 100 percent dividends received deduction, which removes the dividend income from federal tax.[181] The ability of a U.S. parent-U.S. subsidiary together to escape tax on the income of the subsidiary in the territory creates a strong incentive for artificial profit-shifting by U.S. corporations to the territories. The U.S. Treasury has noted that "U.S parents commonly lease plant and equipment to their territorial affiliates, which may have the effect of artificially inflating the income

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the Virgin Islands to the United States, he is arguably not a "first filer." Any change in accounting methods is thus subject to the requirements of the treasury regulations, which provide that the taxpayer must obtain the approval of the Commissioner for the change, and that he make all necessary adjustments to his return to ensure that the change in accounting methods does not result in the omission of any item of income. Reg. §§ 1.446-1(e)(2)(ii) and 1.446-1(e)(3)(i).

For the argument that this tax avoidance technique is legitimate, see Berney, *supra* N. 175, at 229-236, and Danielson, *supra* N. 7 at A-33.

[178] In Ramsey v. Chaco, 549 F.2d 1335 (9th Cir. 1977), the Ninth Circuit held that provisions of Guam law granting income tax rebates to eligible investors are not violative of section 31 of the Organic Act, since failure to annul the original rebate bill within one year of its submission to Congress constituted an implied congressional approval under the then existing provision of the Organic Act. In the case of the Virgin Islands, the right to rebate income taxes is limited by I.R.C. § 934, providing that income tax rebates may be granted only with respect to Virgin Islands source income, and that a recipient of an income tax rebate must be either an individual resident of the Virgin Islands or a corporation that derives 80 percent or more of its gross income from the Virgin Islands and 50 percent or more of its gross income from the active conduct of a trade or business in the Virgin Islands.

[179] V.I. Code Ann. tit. 29, ch. 12; Guam Civ. Code §§ 53577-79. *See also* Washington Post, June 22, 1981 (Washington Business), at 17. The amount of income taxes rebated by the Virgin Islands from 1973 through 1979 was $167 million, or 55 percent of corporate taxes collected under the Internal Revenue Code. (U.S. Gov't Comptroller for the Virgin Islands.) The tax incentive legislation of the Virgin Islands and Guam provides tax benefits comparable to those offered by Puerto Rico under its Industrial Incentive Acts. See U.S. DEP'T OF TREASURY, THE OPERATION AND EFFECT OF THE POSSESSIONS CORPORATION SYSTEM OF TAXATION, 3d Ann. Rep. (1980).

[180] 48 U.S.C. § 1642 (Supp. 1979); I.R.C. § 936.

[181] I.R.C. § 243.

subject to a territorial tax rebate."[182] U.S. parent companies also have transferred title to patents, trademarks and other intangibles to their possessions corporations, and have used transfer prices on sales of manufactured goods from the subsidiaries back to the parent which allocate the return on the intangibles to the subsidiaries. This practice has been contested by the Service under section 482 on the ground that the transfers lacked substance and were motivated solely by tax avoidance.[183]

Abuses also occur where particular Code provisions fail to make allowance for the special status of the Virgin Islands and Guam. One such instance arises under the foreign tax credit provisions. These provisions limit the foreign tax credits to the amount of U.S. tax liability on the taxpayer's foreign source income. The purpose of this limitation is to ensure that foreign tax credits offset only U.S. tax on foreign source income. However, the foreign tax credit rules fail to take into account the fact that a U.S. corporation may be an inhabitant of the Virgin Islands. As explained above, income earned by a U.S. subsidiary which qualifies as an inhabitant of the Virgin Islands is not subject to double taxation because it is not subject to U.S. tax at all. Nonetheless, the foreign tax credit provisions do not deny the foreign tax credit with respect to Virgin Islands withholding tax on dividends received from a U.S.-chartered inhabitant of the Virgin Islands.[184] The foreign tax credit, in this instance, has the effect of sheltering U.S. source income rather than, as intended by Congress, preventing double taxation of foreign source income.

A recent example of U.S. tax law failing to take into account the special U.S.-Virgin Islands income tax relationship is the Foreign Investment in U.S. Real Property Tax Act (FIRPTA).[185] FIRPTA added new section 897 to the Code, which provides that the following will be deemed income effectively connected with a U.S. trade or business:

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[182] TERRITORIAL INCOME TAX SYSTEMS, *supra* N. 7, at 40.

[183] Eli Lilly & Co., No. 5113-76 (T.C., filed June 9, 1976); G.D. Searle & Co., No. 12836-79 (T.C., filed Sept. 15, 1979). These cases involve corporations operating in Puerto Rico, but the law governing these corporations applies equally to a number of other territories, including Guam.

[184] Section 904(a) limits the available foreign tax credit to that fraction of U.S. tax which foreign source taxable income bears to all taxable income. Earnings of a subsidiary chartered in the United States but qualifying as an inhabitant of the Virgin Islands are not subject to U.S. tax; nor, by virtue of section 243, are those earnings taxed by the United States when paid as a dividend to a U.S. parent corporation. *See* Rev. Rul. 80-40, 1980-1 C.B. 175. Thus, tax withheld on the dividend by the Virgin Islands can in some circumstances generate a credit for foreign taxes paid on income wholly free from U.S. tax.

[185] Foreign Investment in Real Property Tax Act of 1980 (cited herein as FIRPTA), Pub. L. No. 96-499, §§ 1121-1125, 94 Stat. 2682.

> (1) gain realized by a foreign corporation or nonresident alien from the disposition of an interest in U.S. real property, and
>
> (2) gain realized by a foreign shareholder on his interest in a U.S. corporation if half or more of the corporation's real property and business assets consists of U.S. real property.

FIRPTA also limited the ability of a foreign corporation to distribute an interest in U.S. real property without recognizing gain, or to avail itself of the benefits of a tax-free sale incident to liquidation under section 337.[166] This legislation was a response to political pressure to close the loopholes that until 1980 permitted foreigners who invested in U.S. farmland and other U.S. real estate to escape federal tax on their capital gains.[167]

Tax practitioners discovered that FIRPTA can be circumvented by forming a Virgin Islands corporation to hold U.S. real property. Such a corporation avoids taxation under section 897 by virtue of the Revised Organic Act of the Virgin Islands, pursuant to which inhabitants of the Virgin Islands satisfy their U.S. tax obligations by paying tax to the Virgin Islands.[168] By means of a sale of the real estate and liquidation under section 337 of the mirrored Virgin Islands Code, the Virgin Islands corporation can avoid tax liability to the Virgin Islands on gain from the sale of U.S. real estate. The benefits of a tax-free liquidation under section 337 are available to the Virgin Islands corporation because, with respect to the Virgin Islands, it is a domestic corporation. The foreign shareholders' capital gain on the disposition of their stock in the Virgin Islands corporation, upon liquidation or otherwise, is in turn exempt from both U.S. and Virgin Islands taxes. Section 897 of the Code does not apply to shareholders of a corporation chartered outside the United States; and the Virgin Islands mirrored Code does not apply to gain realized on U.S. real estate or stock of specified corporations, but rather to gain from Virgin Islands real estate or stock of certain Virgin Islands corporations.[189]

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[166] I.R.C. § 897(d).

[167] See *Hearings on S. 192 and S. 208 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee on June 25, 1979* (statement of Donald C. Lubick, Assistant Treasury Secretary for Tax Policy); Feder & Parker, *The Foreign Investment in Real Property Tax Act of 1980*, 34 TAX LAW. 547 (1981); U.S. DEP'T OF TREASURY, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE (1979).

[168] See the text accompanying Ns. 73–75 *supra*.

The administration became aware of this loophole in FIRPTA in time to close it through technical corrections enacted as part of the Economic Recovery Tax Act of 1981.[190] A U.S. real property interest under section 897 was redefined as "an interest in real estate located in the United States or the Virgin Islands." Under this definition, a foreign shareholder of a Virgin Islands corporation will be subject to tax on gain on the disposition of U.S. or Virgin Islands real property under the mirrored section 897. The amendment further provides that a person subject to tax because of section 897 will pay that tax and file the necessary returns with the United States with respect to a direct interest in U.S. real property or an interest in a U.S.-chartered corporation, and with the Virgin Islands with respect to an interest in Virgin Islands real property or in a Virgin Islands-chartered corporation.[191]

As Congress continues to amend the Code, new opportunities for tax avoidance and evasion will arise as a result of the unique tax status of the Virgin Islands and Guam. Rarely do legislators recognize that separate taxing jurisdictions must interpret the Code in a mirrored image, and that an inhabitant of the Virgin Islands satisfies its U.S. income tax obligations on worldwide income by paying tax to the Virgin Islands under Code provisions applicable to domestic persons.

Does the United States-Territorial Tax Relationship Promote Territorial Fiscal Autonomy?

The historic rationale of the preferential tax arrangements for the Virgin Islands and Guam was to channel federal support to the territories in a way that would also promote territorial fiscal autonomy. The tax preferences were seen as an alternative to annual federal funding of territorial government operations. By enacting, in effect, 100 percent revenue sharing for taxes derived from the territories and, in addition, earmarking for the territories certain U.S. source revenues, Congress anticipated that the governments of the Virgin Islands and Guam would become self-sustaining.[192]

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[189] For the period that the Virgin Islands company is holding the U.S. real estate, it may pay dividends to its foreign shareholders and interest to its U.S. mortgagor without being subject to the requirement to withhold a 30 percent tax, provided that less than 20 percent of its gross income is derived from Virgin Islands sources. I.R.C. §§ 861(a)(1)(B), 862(a)(2)(A), 871(a), 881(a). The holding company would be subject to Virgin Island corporate tax on its worldwide income, but real estate corporations typically report losses for tax purposes, rather than positive taxable income. U.S. DEP'T OF TREASURY, TAXATION OF FOREIGN INVESTMENT IN U.S. REAL ESTATE (1979) (tables 2-3 through 2-5).

[190] Economic Recovery Tax Act of 1981, § 831(a) (codified at I.R.C. § 897(c)(1)(A)(i)).

[191] *Id.* § 831(f) (codified at I.R.C. § 6039C(f)).

In the 1950s and 1960s, these financing arrangements did accomplish the intended result. *Ad hoc* appropriations to the territories in these years were principally for disaster relief. In the 1970s, however, both the Virgin Islands and Guam accumulated large deficits. The Department of the Interior periodically warned that bankruptcy was imminent,[193] but after 1970, had no power to impose fiscal austerity.[194] To finance the territorial deficits, Congress appropriated special grants,[195] authorized federal financing bank loans,[196] and provided for prepayment to the Virgin Islands of the rum fund [197] and advance payment to Guam of income taxes withheld from members of the U.S. armed forces stationed there.[198] Table 1 shows that total *ad hoc* assistance between 1977 and 1980 amounted to $68 million for the Virgin Islands and $81 million for Guam.[199]

What went wrong? Table 1 suggests that demand for government

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[192] See the text beginning at Ns. 61, 119, 154 *supra*. See also 125 CONG. REC. 16894 (daily ed. Nov. 16, 1979) (remarks of Sen. Johnston). The Virgin Islands and Guam are also eligible for approximately one half of federal grant-in-aid programs. See U.S. DEP'T OF INTERIOR, FEDERAL PROGRAMS AVAILABLE TO THE TERRITORIES OF THE UNITED STATES (1978).

[193] The July 1979 report of the Federal Comptroller for the Virgin Islands stated on page 5: "The financial condition of the Territorial Government continues to worsen at a rapid pace and is now at a point where a virtual bankruptcy situation could exist in the near future. . . . Potential sources of increased revenues do exist in amounts sufficient to reverse the trend of deficit spending." The August 1979 report of the Federal Comptroller for Guam stated on page i: "The Government of Guam's fiscal difficulties have grown more critical each year since 1974 . . . we anticipate that Guam could incur a cash shortfall of $30 million by the end of FY 80, unless immediate corrective measures are taken."

[194] In November 1970, the people of the Virgin Islands and Guam each elected their first governor. Since 1971, the Department of the Interior has exercised no direct control over the territorial governments. Virgin Islands Elective Governor Act, § 4, 48 U.S.C. § 1591 (1968); Guam Elective Governor Act, § 1, 48 U.S.C. § 1422 (1968).

[195] Many of these grants were to offset reductions in territorial tax revenues resulting from changes in the federal income tax. See the text accompanying Ns. 202–204 *infra*.

[196] 48 U.S.C. § 1574b (1976). Pub. L. No. 96–205, § 303, 94 Stat. 88 (1980) (to be codified at 48 U.S.C. § 1423a).

[197] 48 U.S.C. § 1645 (Supp. 1979).

[198] 48 U.S.C. § 1421h (Supp. 1979).

[199] Not included in this amount is the foregiveness of interest and principal on the $33 million balance of a loan owed by Guam to the U.S. government. Pub. L. No. 96–205, § 302, 94 Stat. 88 (1980); Pub. L. No. 96–597, § 201, 94 Stat. 3477 (1980).

Table 1

General Fund Expenditures, Income Tax and Income Tax Effort, and Federal *Ad Hoc* Assistance, 1971–1980 [1]

(Dollars in millions)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
VIRGIN ISLANDS										
General Fund										
(1) Expenditures	76.5	91.8	104.1	110.1	121.9	128.3	124.8	135.1	149.0	*
(2) Operating surplus/deficit	(3.4)	2.6	(15.6)	(7.4)	(20.2)	(29.2)	(21.0)	(25.3)	(5.3)	*
Income Tax										
(3) Individual [2]	32.5	36.7	39.0	35.8	47.6	41.2	39.0	35.1	47.0	*
(4) Corporate [3]	15.2	19.9	14.8	27.4	14.7	10.1	19.8	17.0	*	*
(5) Total as percentage of gross territorial product [4]	18.1%	18.1%	13.6%	15.1%	13.6%	10.6%	11.3%	10.0%	*	*
Federal ad hoc assistance [5]										
(6) Grants	2.7 [6]	2.7	2.7	2.7	5.7	2.7	8.5	14.5	0	49.0 [7]
(7) Loans	0	0	0	0	0	0	22.0	0	9.0	0
GUAM										
General Fund										
(8) Expenditures	*	71.9	85.7	108.5	133.1	115.1	125.9	143.3	160.4	*
(9) Operating surplus/deficit	*	3.3	9.7	1.3	(20.1)	(19.9)	(3.6)	(10.3)	7.2	(21.6) [8]
Income Tax										
(10) Total revenues [2]	29.5	38.7	46.0	50.8	49.2	36.8	30.9	41.5	60.4	*
(11) Total as percentage of gross territorial product [4]	*	*	11.1%	11.0%	10.3%	7.7%	*	*	*	*
Federal ad hoc assistance [5] (excluding typhoon relief)							15.0	29.1	9.2	26.0 [7]
(12) Grants	0	0	0	0	0	0				
(13) Loans	0	0	0	0	0	0	0	0	36.0	0

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* Not available.

[1] Figures for federal assistance are on the basis of U.S. fiscal years. All other figures are on the basis of territorial fiscal years. Until 1979 the fiscal years of the Virgin Islands and Guam ended on June 30. Since 1979, territorial fiscal years have ended on September 30 (U.S. fiscal year). Figures for transition quarters are not shown.

[2] Net of refunds. The source documents show individual and corporate taxes on a gross basis and present only one figure for income tax refunds. That figure has been assumed to consist mainly of individual income taxes and has been deducted from them.

[3] Net of rebates, which averaged $22 million per year in the Virgin Islands and rose in Guam from approximately $100,000 in 1971 and 1972 to $4 million in 1977 and 1978.

[4] Computed on the basis of the average of the gross territorial product for the two calendar years straddled by the fiscal year.

[5] *Ad hoc* assistance includes all federal assistance for the territorial governments, other than grants-in-aid (which, in many cases, are available to the territories on the same basis as to the 50 states) and transfers of earmarked federal taxes.

[6] Between 1968 and 1976, annual payments of $2.7 million were made by Hess Oil Corporation to the Virgin Islands in consideration of a 14,000 barrel per day oil product import quota issued by the Secretary of the Interior in 1967.

[7] Includes $28 million in advance payments to the Virgin Islands of estimated federal taxes on V.I. rum shipments to the United States, and $16.3 million in advance payments to Guam of estimated U.S. income taxes withheld from federal government employees in Guam. The change in timing of the payment under Pub. L. No. 95-348 resulted in a double payment in fiscal year 1980, one half of which is counted as *ad hoc* federal assistance. See *Appendix to the Budget of the United States Government* (fiscal year 1982) at I-M169.

[8] Excess of General Fund appropriations as of April 11, 1980, over estimated General Fund revenues for fiscal year 1980.

Sources: Lines (1) and (2) are from U.S. Interior Department, U.S. Government Comptroller for the Virgin Islands, *Financial Condition of the Government of the Virgin Islands of the United States* (hereinafter, *V.I. Comptroller's Report*), various years. All years except 1979 shown in lines (3) and (4) are from Virgin Islands Department of Finance, *Annual Report on Financial Operations*, FY 1977 and 1978. The figure shown for 1979 is revenue less imputed reserve for income tax refunds reported in *V.I. Comptroller's Report, FY 1979*. Line (5) is based on gross territorial product statistics estimated by Jerome McElroy in V.I. Department of Commerce, "Comparative Growth Statistics." Lines (6) and (12) are based on *Budget of the U.S. Government*, various years, and Federal appropriation acts for the Interior Department. Lines (7) and (13) are from U.S. Treasury, Federal Financing Bank. Lines (8) and (9) are from U.S. Interior Department, U.S. Government Comptroller for Guam/TTPI/NMI, *Audit Report on the Fiscal Condition of the Government of Guam*, various years. All years shown in line (10) except 1971 and 1972 are based on revenues before rebates reported in U.S. Interior Department, U.S. Government Comptroller for Guam, *Audit Report of the Fiscal Condition of the Government of Guam*, annual reports. Gross revenues for 1971 and 1972 were provided by Government of Guam, Department of Revenue and Taxation, which was also the source of income tax rebates accrued under Guam's industrial incentive program. Line (11) is based on gross territorial product statistics estimated in Russell C. Krueger and Clara M. Okada, *The Gross Island Product of Guam*, Guam Department of Commerce, 1978.

services in the territories increased substantially, while resistance to taxation also increased. Despite a sharp rise in U.S. assistance and real economic growth during the 1970s,[200] the Virgin Islands and Guam incurred deficits in almost every year after 1972. Net income tax collections, the main source of local revenues in the Virgin Islands and Guam, were stagnant between 1972 and 1978 in dollar terms; in real terms they declined. As a percentage of Virgin Islands gross territorial product, Virgin Islands income taxes declined from 18 percent in 1971 and 1972, to 10 percent in 1978. In Guam, income taxes declined from 11 percent of gross territorial product in 1973 to less than 8 percent in the period from 1976 through 1978.

un! The Virgin Islands and Guam alleged that a major cause of their decline in income tax revenues was the reduction in individual income tax liabilities provided for by the *federal* revenue laws enacted each year between 1975 and 1978. Since the income tax laws of the Virgin Islands and Guam are "mirrors" of the Code, reductions in the U.S. income tax reduce the liabilities of taxpayers in the territories as well. The territories' lack of control over the locally applicable U.S. income tax laws became the justification for additional federal aid.[201] In 1976, the United States authorized a grant of $8.5 million "to compensate the Virgin Islands for the unexpected revenue loss occasioned by the Tax Reduction Act [of 1975]."[202] The next year, the United States authorized $14 million for the Virgin Islands and $15 million for Guam in order to offset "unexpected revenue losses occasioned by the Tax Reduction Act of 1975 and the Tax Reform Act of 1976."[203] In 1977, statutory tax rates were again reduced by the Tax Reduction and Simplification Act of 1977. Section 407 of the Act authorized payments to the Virgin Islands, Guam and American Samoa, in an amount equal to the loss to the territories with respect to tax returns for 1977 by reason of the reduction in statutory tax rates.[204] Pursuant to this provision, the United States appropriated a total of $6 million to the three territories combined.

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[200] *See* THE ECONOMY OF THE U.S. VIRGIN ISLANDS, *supra* N. 127. GUAM DEP'T OF COMMERCE, STATISTICAL ABSTRACT, recent years.

[201] The year 1975 was the first time that the Virgin Islands sought special grants to compensate for federal tax reductions. Guam did so for the first time in 1976.

[202] 48 U.S.C. § 1574d (1976). *See* S. REP. No. 94-1021, 94th Cong., 2d Sess. 5 (1976).

[203] 26 U.S.C. § 7651 note (Supp. 1979).

[204] Tax Reduction and Simplification Act of 1977, § 407(a). American Samoa was included in this legislation because it had adopted the U.S. income tax laws, with certain modifications, as its local income tax law. See TERRITORIAL INCOME TAX SYSTEMS, *supra* N. 7, at 28-29.

Beginning in 1976, several members of Congress proposed that the loss to the Virgin Islands resulting from changes in the U.S. income tax laws warranted a permanent solution. The proposal was to deposit into the treasury of the Virgin Islands the U.S. excise taxes collected on past and future shipments of Virgin Islands gasoline to the United States.[205] This was the same result which the Virgin Islands sought after 1978 through the courts in *Virgin Islands v. Blumenthal*.[206] In a letter to the President, the Chairman of the House Subcommittee on National Parks and Insular Affairs wrote that the United States was "obligated" to provide additional federal assistance to the Virgin Islands, "since the Virgin Islands deficit has been directly caused by federal actions affecting tax revenues collected."[207] The Chairman went on to state that "since the Federal government has . . . provided some interim relief through partial reimbursement of these tax losses, it seems to me that we must also recognize our special obligation to provide the Virgin Islands with some kind of permanent solution."

The argument for make-up payments to offset reductions in federal tax rates was misleading for two reasons. First, the argument implied that changes in federal tax law reduced territorial welfare. It ignored the fact that the loss to the territorial treasuries was the gain of the territorial taxpayers. If the governments of the Virgin Islands and Guam preferred to maintain their revenues rather than have their taxpayers enjoy reduced tax liabilities, they could have offset reductions resulting from changes in the Code through increases in local taxes. Since 1976 and 1977, respectively, the Virgin Islands and Guam have also had the authority to levy income tax surcharges of up to 10 percent.[208]

Second, the argument for make-up payments presumed that the federal income tax reductions significantly reduced territorial revenues in real terms. In fact, the main effect of the changes in the federal individual income tax under the revenue acts of 1975, 1976, 1977 and 1978 was to offset the automatic tax increases that result from the tendency of inflation to subject individuals to higher tax rates.[209] On the basis of an analysis of both U.S. tax law and income distribution in the Virgin Islands,[210] the U.S. Treasury concluded that "[t]he tax law changes [between 1973 and 1978] could not be the sole or even the primary cause for the sharp decline in the ratio of tax collections to gross V.I. product after 1973." [211]

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[205] Three bills were proposed on behalf of the Virgin Islands that would have provided for the transfer of these taxes to the Islands through an amendment to I.R.C. § 7652. S. 2998, 94th Cong., 2d Sess. § 4; H.R. 6110, 95th Cong., 1st Sess. § 401(a) (1977); S. 2821, 95th Cong., 2d Sess. § 16(b) (1978).

[206] See the text accompanying Ns. 33–43 *supra*.

[207] Letter from Congressman Phillip Burton to President Carter (Oct. 7, 1977).

[208] 48 U.S.C. § 1397 (1976); 48 U.S.C. § 1421i(a); (Supp. 1979).

[209] TERRITORIAL INCOME TAX SYSTEMS, *supra* N. 7, at 10–13, 34–35. This report showed that, assuming that the nominal earnings of taxpayers kept pace with inflation, the ratio of federal individual income taxes to earned income tended slightly to increase at virtually all income levels between 1973 and 1978, despite the reductions in statutory tax rates. On the conservative assumption that nominal

A 1979 report by the staff of the Virgin Islands Legislature Committee on Finance also discounted the effect of U.S. tax law changes on Virgin Islands tax performance.[212] This study estimated that the actual level of individual income tax collections in 1978 was slightly less than 60 percent of potential revenues, taking into account the growth of Virgin Islands incomes after 1970 and changes in the federal income tax laws. This report, which also studied changes in the level of receipts from local Virgin Islands taxes, concluded that "it appears that a policy has been established to forego enforcement of the Virgin Islands internal revenue laws,[213] and to seek, instead, to subsidize the resulting shortfalls of revenues by incursions into the U.S. Treasury." [214]

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incomes in the Virgin Islands increased at an annual rate two percentage points less than the average U.S. inflation rate, the report found that the average effective tax rate in the Virgin Islands should have dropped by only 8 percent between 1973 and 1978—from 7.2 percent of taxable income to 6.6 percent. The actual collections of individual income taxes in the Virgin Islands fell by 14 percent—from $38 million to less than $33 million between 1973 and 1978—an astounding result in view of the substantial growth in the Virgin Islands economy in this period and rates of inflation in excess of U.S. mainland rates.

[210] *Id.* at 33-34. The average effective tax rates were estimated by weighting the effective U.S. tax rate for each income level and filing status by the percentage of Virgin Islands taxpayers subject to that rate. The income distribution and filing status data were derived from a random sample of 200 individual income tax returns filed with the Virgin Islands for tax year 1977.

[211] *Id.* at 34. The report did not provide direct evidence of deficiencies in tax administration or compliance. Such evidence is provided in Internal Revenue Service, Report on Internal Audit of the Virgin Islands Tax Division (various years). *See also* Report of the Comptroller General of the United States, Government of Guam's Effectiveness in Administering its Territorial Income Tax Laws (1979), and U.S. Dep't of the Interior, Audit Report on the Department of Revenue and Taxation, Government of Guam (1975).

[212] Committee on Finance, Virgin Islands Legislature, A Study of the Collection of Revenues in the Virgin Islands for 1978 (June 1979).

[213] The reference is to the U.S. income tax laws, made applicable to the Virgin Islands pursuant to 48 U.S.C. § 1397 (1921), and to locally enacted Virgin Islands tax laws.

[214] Committee on Finance, Virgin Islands Legislature, *supra* N. 212, at vii.

Alternatives to the Present Federal-Territorial Income Tax Relationship

The mirror system may be described as one income tax law servicing three independent tax jurisdictions. The mirror system operates differently in the Virgin Islands and Guam, but in both cases gives rise to legal confusion and opportunities for federal tax avoidance and evasion, while it places an unreasonable and inappropriate administrative burden on the territories. Two paths to reform are possible. Both approaches assume that the territories, which have no voting representation in Congress, will continue to be exempt from taxation for the support of federal programs.

A Unified Federal-Territorial Income Tax System

options

The most direct solution, which has been considered in the past,[215] would be to extend the U.S. income tax jurisdiction to include the Virgin Islands and Guam,[216] and to remit all taxes attributable to these territories to the territorial treasuries. All individuals and corporations resident in or deriving income from the Virgin Islands or Guam would be treated in the same way as stateside individuals and corporations. To preserve the federal assistance which the Virgin Islands and Guam currently receive, the Service would remit to each territory (1) the full amount of federal income taxes paid by its end-of-year residents; (2) in the case of nonresident individuals, a prorated amount of federal taxes based on the ratio of territorial source income to worldwide income; and (3) in the case of corporations, a prorated amount of federal taxes based on the ratio of territorial source income to combined territorial and U.S. source income. This formula would provide a division of revenues between the United States and the territories comparable to that under present law.[217]

Extension of U.S. income tax jurisdiction to the territories would be a radical simplification of current law and would resolve all of the ambiguities therein. The amount of federal revenue sharing would be based on apportionment by the Service, rather than on application of the mirror theory to each taxpayer residing in or deriving income from the Virgin Islands, and to each corporation chartered or operating in Guam. Taxpayers would have to file only one income tax return. The only special burden on taxpayers would be the requirement that corporations and certain individuals receiving income from the Virgin Islands or Guam file an information return reporting their income according to source.[218] Territorial residents would not have to file such an information return, except in the unlikely case that a resident of the Virgin Islands (or Guam) received income from Guam (or the Virgin Islands). The territories would be freed from the statutory requirement that they administer the unwieldy and constantly changing U.S. income tax laws, but would continue to receive the revenues collected in the territories under those laws. Administration by the Service should increase territorial tax revenues through improved collection and compliance. In addition, the potential for tax evasion would be reduced by bringing U.S. citizens and corporations under the common tax administration of the Service.

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[215] It was considered by, among others, the 1970 Interagency Committee on the Virgin Islands, the 96th Congress, and the Carter administration.

[216] This could be accomplished by redefining the term "United States" in I.R.C. § 7701(a)(9) to include the Virgin Islands and Guam.

[217] For a detailed comparison of the amount of federal revenue sharing provided by current law and the above formula, see letter from Donald C. Lubick, Assistant Secretary for Tax Policy, U.S. Treasury, to Paul M. Calvo, Governor of Guam (Jan. 7, 1980).

A proposal for a unified federal-territorial income tax was introduced by Senator Bennett Johnston in November 1979.[219] In February 1980, President Carter announced that he supported the proposal to replace the mirror systems with direct extension of the U.S. income tax system, and that he would submit similar legislation.[220] Senator Johnston and the Carter Administration viewed the proposal as a solution to the technical flaws in the mirror systems and as a means to increase the revenues available to the financially pressed territorial governments.[221]

Despite the advantages of this proposal, its drawback is that it represents a change in the long-standing federal policy toward increased autonomy for the territories. The territorial leaders look upon their authority to administer the locally applicable income tax laws as a basic attribute of self-government.[222] The government of Guam viewed the Carter bill as a "tax 'take-over' proposal [which] threatens to gut the very substance of our political life as a self-governing territory."[223] The territories also perceived a conflict between the Service's interest in enforcing the law and their own concern that the territorial share of total revenues be maximized. Such a conflict could arise in the application of residence rules and transfer pricing standards. Territorial opposition to this proposal persuaded the Carter administration to postpone indefinitely the transmittal of its bill to Congress, with the result that the Senate did not take up the issue of the territories' tax status in 1979 or 1980.

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[218] Such a requirement currently applies to certain high-income individuals resident in or deriving income from Guam. I.R.C. § 7654(a). A similar requirement applies as well to individuals and corporations which claim a foreign tax credit. I.R.C. § 904.

[219] S. 2017, 96th Cong., 1st Sess. (1979). That bill applied not only to the Virgin Islands and Guam, but also to the Northern Mariana Islands and American Samoa. The Northern Mariana Islands was included in the proposal because, under 1976 law, all federal tax arrangements for Guam apply equally to the Northern Marianas. See the text accompanying Ns. 228–230 *infra*.

[220] White House Press Release (Feb. 14, 1980). The Carter administration prepared such a bill and circulated it widely in the territories. The bill was never officially transmitted to the Congress, but nonetheless was reflected in the federal budget for fiscal year 1982, submitted in January 1981 by the outgoing Carter administration.

[221] 125 CONG. REC. S16894–16896 (daily ed. Nov. 16, 1979), and White House Press Release (Feb. 14, 1980). See also Letters from G. William Miller, U.S. Secretary of the Treasury, to Juan Luis, Governor of the Virgin Islands, and to Paul M. Calvo, Governor of Guam (both dated Sept. 26, 1980).

Independent Federal and Territorial Income Tax Systems

Rather than solving the problem of meshing the U.S. income tax and the mirror systems by unifying the federal and territorial income tax jurisdictions, the problems of tax harmonization could be resolved by granting the Virgin Islands and Guam autonomy over locally applicable income tax laws. That is, the Virgin Islands and Guam would administer their own territorial income tax imposed under local law, and would be treated for certain purposes under the Code like a foreign country, subject to the safeguards built into the Code to combat tax avoidance and evasion by U.S. taxpayers who reside in or derive income from a foreign country. However, U.S. citizens who were resident in the Virgin Islands or Guam at the end of the tax year would be exempt from U.S. tax on territorial source income. Such an exemption currently applies to full-year residents of Puerto Rico, who can exclude, under section 933, all income derived from sources within Puerto Rico (except amounts received as U.S. government salaries).[224] The United States would prevent double taxation with respect to foreign source income by allowing a dollar-for-dollar foreign tax credit for taxes paid to the Virgin Islands or Guam.

The federal government would provide financial and technical assistance in helping the territories develop alternatives to their present income tax law, in administering whatever laws are in place, and in training local people to administer the tax laws.[225] The territories would be encouraged to design an income tax which was simpler and more broadly based than the Internal Revenue Code, and which was not automatically changed each time Congress amended the federal income tax laws. To reduce the burden of enacting separate definitions of the tax base, the territories might choose, as 21 of the 50 states have, to incorporate the Code's definition of gross income into their own individual and corporate income taxes.[226] To ensure that the Virgin Islands and Guam obtain the same level of federal assistance under this proposal as they receive under current law, federal taxes paid by U.S. citizens resident in the Virgin Islands or Guam would be remitted to the territory.[227] Provision for the transfer to the territory of all U.S. taxes from sources outside the territory also has the advantage that it eliminates the need for the territory to enforce a tax on foreign source income.

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[222] *See, e.g.*, letter to G. William Miller, Secretary of the U.S. Treasury, from Juan Luis, Governor of the Virgin Islands (July 18, 1980).

[223] Letter to Wallace Green, Deputy Under Secretary of the U.S. Interior Department, from Paul M. Calvo, Governor of Guam (Oct. 9, 1980).

[224] See the text accompanying Ns. 44–46 *supra*.

[225] Similar efforts have taken place between the United States and developing

This reform would provide a straightforward system for harmonizing the federal and territorial income tax jurisdictions. U.S. citizens resident in the Virgin Islands or Guam as of the end of their tax year would be subject to federal income tax on their worldwide income with the exception of territorial source income. The territorial income tax would take the place of the U.S. income tax with respect to income derived from the territory by territorial residents. The United States would transfer to the territory any federal income taxes paid by territorial residents. This reform would resolve the technical problems created by the mirror systems, with no loss in territorial autonomy or potential territorial revenues.

Epilogue and Conclusions

A pattern once set is hard to break. Although the federal revenue sharing provisions for the Virgin Islands and Guam are riddled with

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countries. The Service provides technical assistance in tax administration to developing countries through its Tax Advisory Assistance Staff (in general, funded by AID), and also provides assistance in drafting tax laws to a few developing countries on a reimbursable basis. *See* Oldman & Surrey, *Technical Assistance in Taxation in Developing Countries*, Modern Fiscal Issues: Essays in Honor of Carl S. Shoup 278 (Bird & Head eds. 1972).

[226] National Governor's Association, Info Letter—Federal Tax Policy: Implications for the States 5 (Jan. 15, 1981).

[227] Although federal taxes paid by U.S. citizens resident in Puerto Rico are not remitted to Puerto Rico, it does enjoy primary jurisdiction to tax the income of its residents which is sourced outside the United States. Thus, a resident of Puerto Rico is entitled to claim a foreign tax credit against his U.S. tax liability for Puerto Rican taxes paid with respect to income from sources abroad. Because Puerto Rico's individual tax rates are somewhat higher than those in the United States, the foreign tax credit generally offsets any U.S. liability with respect to that income.

complexities and have not provided the hoped-for territorial financial autonomy, the U.S. tax relationship with the newly acquired territory of the Northern Mariana Islands was set in the same mold.

The Northern Marianas

The Northern Marianas is a group of Pacific islands with a 1980 population of approximately 17,000. After World War II, jurisdiction over the islands was transferred from Japan, under a League of Nations mandate, to the United States, under a trusteeship agreement with the United Nations. In 1976, the Northern Marianas affiliated with the United States as a self-governing commonwealth.[228] The covenant establishing the commonwealth sets out the federal income tax relationship with these islands. Section 601 provides that U.S. citizens [229] resident in the Northern Marianas will satisfy their U.S. income tax obligations by paying the tax due on their worldwide income to the Northern Marianas. The Northern Marianas will administer the U.S. income tax laws as a separate territorial income tax "in the same manner as those laws are administered in Guam." Under section 602 of the covenant, the Marianas can impose additional taxes under local law, and can provide for rebate of taxes received by it on Marianas source income. Section 703 of the covenant, using language identical to that which authorizes the rum fund for Puerto Rico and the Virgin Islands, requires the United States to transfer to the Northern Marianas "the proceeds of all taxes collected under the internal revenue laws of the United States on articles produced in the Northern Mariana Islands and transported to the United States." [230]

Responding to difficulties foreseen in implementing the U.S. income tax laws, the Northern Marianas legislature provided for the 100 percent abatement of the mirror tax on Northern Marianas source income.[231] Congress subsequently declared this to be "contrary to the intent" of the covenant and delayed the effective date of the mirror system (as applicable to Northern Marianas source income) until 1981.[232] Congress also authorized the Internal Revenue Service, upon the request of the Northern Marianas, "to administer and enforce" the mirror income tax in the Northern Marianas free of cost to the territory.[233] Representatives of the Northern Marianas government explored this possibility with the Service in several meetings from 1979 through 1981. The meetings were unproductive because the Northern Marianas and the Service were unable to agree on the sharing of ultimate authority over the administration of the income tax.[234]

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[228] 48 U.S.C. § 1681 note (1976). See N. 16 *supra*.

[229] Sections 301-303 of the Covenant to Establish a Commonwealth of the Northern Mariana Islands grant U.S. citizenship to all persons who are domiciled in the Northern Marianas and who do not owe allegiance to a foreign state, effective with formal termination of the United Nations trusteeship agreement. All persons born in the Northern Marianas after that date will be U.S. citizens at birth.

[230] At present, the Northern Marianas does not export to the United States any goods, such as alcoholic beverages or tobacco products, which are subject to a U.S. manufacturer's excise tax. The Northern Marianas thus does not currently benefit from this provision.

[231] Pub. L. No. 1-30 of the Northern Mariana Islands, ch. 2 §§ 1-5 (1979).

Seeing that no solution had been worked out for the administration of the mirror system, Congress, in December 1980, again extended the effective date of the mirror system as applicable to Northern Marianas source income. The new effective date is January 1983.[235] At present, the operating expenses of the Northern Marianas government are financed by a graduated gross income tax imposed under Northern Marianas law, and by the annual U.S. grant provided under the covenant through 1987.[236]

Practical Problems

Those who have espoused the use of the federal tax system to finance the territories have not thought through the practical problems to which such arrangements give rise. This article has highlighted the problems that have been created by the special federal tax relationship with the Virgin Islands and Guam. Both the grant to the Virgin Islands (and Puerto Rico) of certain federal excise taxes—the so-called rum fund—and the grant of the right to collect federal income tax locally are inherently flawed.

The U.S. Department of the Interior report on the Virgin Islands economy implies that the rum fund is a complex and wasteful system for "the shifting of fiscal levies among consumers, producers, the Federal Government and the Virgin Islands Government."[237] Consumers pay a high duty on foreign rum in order to protect the Virgin Islands (and Puerto Rican) rum producer, and also pay the federal excise tax applicable to all alcoholic beverages. The excise tax on rum produced in the Virgin Islands or Puerto Rico is transferred from the U.S. Treasury to the territories, which in turn subsidize the local rum industries. The Interior Department report states:

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[232] Pub. L. No. 96–205, § 205(a), 205(c), 94 Stat. 87 (1980).

[233] Pub. L. No. 95–348, § 3(d), 92 Stat. 489 (48 U.S.C. § 1681 note (Supp. 1979)), *amended by* Pub. L. No. 96–205, § 204, 94 Stat. 86 (1980).

[234] See letter from Jerome Kurtz, Commissioner of Internal Revenue, to Carlos Camacho, Governor of the Northern Mariana Islands (Sept. 24, 1979).

[235] Pub. L. No. 96–597, § 303, 94 Stat. 3478 (1980).

[236] Pub. L. No. 94–241, § 704, 90 Stat. 273 (48 U.S.C. § 1681 note (1976)).

[237] THE ECONOMY OF THE U.S. VIRGIN ISLANDS, *supra* N. 127. *See also* the text accompanying Ns. 117–32 *supra*.

> Thus the U.S. consumer and the U.S. Treasury subsidize the Virgin Islands producer and the Virgin Islands treasury. The original object of [the V.I. rum fund] was to encourage local Virgin Islands tax collections by matching them with a transfer payment from the U.S. Government. The payment from the U.S. Government continues, while the incentive no longer applies to the collection of local taxes but to the production of rum.[238]

Mirror Systems

The principal means by which U.S. tax dollars are channelled to the Virgin Islands and Guam are the so-called mirror systems. The mirror systems, as applicable to individual and corporate income taxes in the Virgin Islands and to corporate taxes alone in Guam, involve a transformation of all Internal Revenue Code provisions which make a distinction between foreign source and domestic source income and between foreign and domestic persons. Since taxation of international transactions involves some of the most complex provisions of the Code, the mirror systems are peculiarly susceptible to technical problems. Especially in the Virgin Islands, the mirror system gives rise to difficult problems of interpretation, harsh tax results for some taxpayers and loopholes for other taxpayers. Application of the mirror system to individuals resident in or deriving income from Guam was simplified in 1972. The new scheme, under sections 935 and 7654 of the Code, eliminates the discriminatory treatment of U.S. citizens as foreign persons under the Guam mirror system. However, the new scheme gives rise to inconsistencies between federal laws regarding liability for tax and federal tax withholding obligations.[239]

The purpose of the special federal tax relationship with the Virgin Islands and Guam is to provide these territories an independent source of revenue, and thereby promote their fiscal autonomy.[240] The 1979 Treasury Report noted that: "The most obvious disappointment [with respect to the Virgin Islands and Guam mirror systems] has been in the amount of income tax revenues collected by the territories."[241] Tax collections under the mirror systems were stagnant in the 1970's: as a percentage of gross territorial product, they fell by roughly one third. Substantial evidence exists that a major cause of the decline in tax effort was decreasing tax enforcement and compliance in the territories. Nonetheless, reductions in U.S. income tax rates in the 1970's furnished an argument for providing increased federal appropriations to the territories.[242] Rather than promoting the fiscal autonomy of the territories, linkage between the territorial tax systems and U.S. income tax laws has blurred the responsibility of the Virgin Islands and Guam to assume the burden of fiscal solvency.

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[238] *Id.* at 25.

[239] See the text accompanying Ns. 168–72 *supra.*

[240] See the text beginning at Ns. 51 & 144 *supra;* Rev. Rul. 78–327, 1978–2 C.B. 196; Dudley v. Comm'r, 258 F.2d 182 (3d Cir. 1958); S. 2017, 96th Cong., 1st Sess. (1979).

[241] TERRITORIAL INCOME TAX SYSTEMS, *supra* N. 7, at 2.

Two Possible Approaches

This article outlines two possible approaches to the reform of the federal tax relationship with the Virgin Islands and Guam. The first would extend the U.S. income tax system directly to those territories. All revenues attributable to a territory would be remitted to the territory. The second would make the Virgin Islands and Guam autonomous for purposes of taxation. The United States would exempt from tax the territorial source income of territorial residents, as the Code presently provides for Puerto Rican residents under section 933. Territorial residents would thus be subject to federal tax only on U.S. source income and income sourced in foreign countries. The proceeds of the federal tax on the residents of a territory would be remitted to the territory.

Either of these reforms would end the legal disarray and potential for U.S. tax avoidance and evasion under the present mirror tax systems. The choice involves a trade-off between federal assumption of responsibility for territorial revenues, on the one hand, and territorial autonomy, on the other. The first approach retains the linkage between income tax rates for federal taxpayers and territorial taxpayers. As a result of administration by the Service, this approach would probably result in a substantial increase in territorial revenues. The second approach reflects the U.S. commitment to the fiscal autonomy of the Virgin Islands and Guam. These territories would have authority to develop a tax system suited to their needs and administrative resources, and they would be free to work out their own balance between income tax burdens and local government spending.

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[242] The most recent occasion for a request for a federal appropriation to offset reductions in territorial revenues resulting from a federal tax law change occurred in connection with President Reagan's proposal for a 30 percent tax cut. The request was made on May 21, 1981 in a statement by Rep. de Lugo before the Senate Finance Committee concerning the impact of the Reagan administration's tax proposals on Virgin Islands. See also Res. 15, 16th Guam Legislature (1981) (expressing support for the proposed tax reduction and petitioning the United States to compensate Guam for the loss in territorial revenues). To meet these requests, S.1674, 97th Cong., 1st Sess. § 204 (1981) would authorize appropriations to the Virgin Islands, Guam and American Samoa to offset "any revenue reductions they sustain as a result of the enactment of *any* general federal tax revision or reduction" (emphasis added).

STATEMENT OF

RICHARD B. DIXON

TREASURER AND TAX COLLECTOR
OF LOS ANGELES COUNTY

SUBMITTED FOR
THE RECORD OF THE HEARING

BEFORE THE

SENATE FINANCE COMMITTEE
OF THE UNITED STATES SENATE

ON

JULY 25, 1985

This testimony is submitted on behalf of Los Angeles County which has a population of over 7.8 million people, with a total annual budget exceeding $6 billion. It concerns the President's proposal for drastic revisions of Section 103 of the Internal Revenue Code, which deals with the issuance of tax exempt bonds by state and local governmental units. Quite frankly, these proposals will seriously cripple the ability of local government to provide essential government services to its citizens. Pursuant to the rules of this Committee, it is requested that this testimony be made a part of the record of the hearing held before this Committee on July 25, 1985.

I would like to address three changes to current law proposed by the President, each of which would have a serious impact on our ability to meet our responsibilities to our citizens. These proposals are (1) the so-called "one-percent test," which would hold any bond issue to consist of taxable "nongovernmental bonds" if more than one percent of the proceeds were "used" directly or indirectly by any person other than a State or local government (use of a facility financed by the proceeds would be considered use of those proceeds); (2) expanded restrictions on arbitrage which not only would increase the amount of arbitrage deemed to be present by changing the definition of bond yield, but would also tax the local government issuer by requiring a "rebate" of all arbitrage to the United States; and (3) absolute prohibition of advance refundings.

These measures are intended to put an end to practices which some observers feel are abuses of the current system; but they are overly broad and will accomplish far more than closing loopholes. Adoption of these measures will have the unintended effect of making it virtually impossible for local governments to finance many activities which are undoubtedly governmental, even in the strictest sense of the term, and will also prevent business-like, efficient financial management.

I. The One-Percent Test

In attacking private exploitation of state and local governments' ability to borrow at favorable rates due to the tax-exempt status of interest payments on their obligations, the Treasury has proposed that interest on State and local government bonds would be tax-exempt only if the bonds were "governmental" bonds. Bonds would be governmental bonds only if no more than one percent of the bond proceeds were used directly or indirectly by any person other than a State or local government, including the use of property financed with those proceeds. Thus, bonds would be classified according to who occupies or manages portions of a facility, rather than the purpose of the facility.

Opponents of so-called "private-purpose" bond issues argue that they distort the economy, cause relocation of business and jobs, and erode the federal income tax base. Supporters of these bonds claim that they are an efficient way to stimulate the economy, have a positive effect on our balance of payments problems by encouraging investments located in the United States rather than overseas, and in practice have little, if any, negative impact on federal revenues.

The economic arguments on both sides are quite complex and will not be resolved by this testimony. Even if one were to ignore the favorable arguments and accept the anti-bond arguments, however, the one-percent test would be the wrong way to address the problem. This is because it hits a far broader target than that at which it is aimed. It does not merely prevent the possibility of private concerns benefiting unfairly from favorable financing available to local governments; rather, it would do away with a whole range of financings, including those where the primary or sole purpose of the project is undeniably governmental, no matter how narrowly that term is construed.

For example, consider bonds issued to finance the construction of a new county office building. Presumably no one would argue that this is anything other than a governmental function. But even so, the bonds would lose their tax exempt status if more than one percent of the floorspace of that building were used by a nongovernmental entity. Such a situation is not hard to conceive. For instance, for the convenience of county employees, the building could contain a cafeteria. If the county directly operated the cafeteria, presumably there would be no problem; if, on the other hand, the county determined that it would be less expensive and more efficient for a private contractor to operate the cafeteria, it would run afoul of the one percent test and the bonds would lose their tax-exempt status.

In an evident attempt to ameliorate the above result, the President's proposal contains a rather vague scheme for allocation between governmental and nongovernmental users. While the precise operation of this provision is unclear, it might apply to the above example by disallowing tax-exempt treatment for that portion of construction costs attributable to the cafeteria, while costs associated with the remainder of the project would be eligible for tax-exempt financing.

This proposal presents two very serious problems. In the first place, it simply does not make sense to apply any user-based restriction to such situations. Regardless of who runs the cafeteria, it is obviously in the government's interest to provide a convenient place for its employees to have lunch. Even if the cafeteria is operated by a private company, the evils at which the proposal is aimed (such as unfair competition and inefficient allocation of business locations between jurisdictions) simply are not present in this case; there is no public subsidization of a private interest.

Equally important, the allocation rule is unworkable in any but the simplest situation, where the respective proportions of use remain constant over the life of the bonds. For instance, assume that the county has a pressing need for 12,000 square feet of additional office space, and therefore decides to construct a new building. Its engineers and financial officers determine that, given economies of scale and a favorable economic climate, it makes sense to construct a 15,000 square foot building, especially since projections show that the additional space will be necessary within three years. Obviously, it would merely be good common sense to construct the larger building and lease a portion of it to other users on a short-term basis, gradually expanding into that space as necessity dictates. Under the President's proposal, the county would be foreclosed from this option. It would either have to build the smaller office, necessitating new construction just a few years later (when it is possible interest rates could have risen to unmanageable levels); or construct the larger building and let a large amount of its floorspace go unused, clearly an inefficient use of resources; or, finally, attempt to allocate between governmental and nongovernmental use.

Yet the President's plan does not explain how to allocate between the tax-exempt and taxable portion of the project. If the initial proportion controls, the percentage of taxable bonds would be unfairly overstated, since private use would steadily diminish over time; but it is unclear if any other method of allocation could be used. In other words, the rigid one percent rule would hamper government's ability to respond flexibly to changing circumstances, or to plan ahead on a rational basis.

The foregoing illustrates the difficulties with the one percent rule and the associated allocation scheme in just one fairly straightforward context. Yet these same problems could arise again and again. Sewage and solid waste disposal, resource recovery systems, water supply, correctional institutions, bridges and roads, and schools and libraries are all examples of strictly governmental services or facilities which could be unjustly impacted by this proposal, merely because of private involvement.

Indeed, this brings us to the last point concerning the one-percent test: it will do away with the innovative, economically efficient and rapidly growing practice of "privatization." Privatization simply means that a governmental unit and a private firm work together in partnership to provide services for the community. Privatization is rapidly spreading because it is efficient and beneficial for both parties. For instance, sewage and solid waste disposal has become a highly complex process. It makes sense for local governments to contract with private firms, which have expertise in the subject, to design or operate complex disposal facilities. This allows the locality to have state of the art facilities without having to undergo the costly, time consuming, and wastefully duplicative process of developing its own expertise in the field. In addition, the local government can shift the economic risks of the transaction (for instance, a plant that initially fails to meet performance specifications) to the private party. Finally, some of the most modern methods are actually proprietary, and not available except through the company which has developed the technology.1/

Similarly, many localities have found that the undeniably governmental function of operating criminal corrections facilities is more efficiently carried out by private contractors. Indeed, this Administration's Justice Department

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1/ The proposal contains a de minimis exception, to the effect that a bond issue will not be disqualified by virtue of nongovernmental use if such use is pursuant to a short-term (one year or less) management contract. This exception is completely inadequate for privatization purposes, because usually it is more cost effective to use longer management contracts, especially in cases (such as the aforementioned waste disposal example) where the private contractor provides improvements or equipment, and is subject to high start-up costs. Under such circumstances it would not be profitable for the contractor to enter into a one-year contract. Additionally, given the vague wording of the proposal, it could be read to restrict the exception to a single contract, not a series of one year contracts, which would mean that the benefits of privatization would only be available for one year out of the facility's life.

recently sponsored a seminar encouraging such privatization. Under the Administration's tax reform proposals, however, such programs would be sharply curtailed, at least for new facilities, since whatever economies would otherwise result from privatization could be more than offset by increased borrowing costs resulting from loss of tax-exempt status.

The examples offered are just the tip of the iceberg. Indeed, Los Angeles County alone has saved more than $60 million over the last six years through effective use of privatization.

In focusing on who uses the facility, as opposed to what function the facility serves, the President's plan goes far beyond its stated intention of preventing private exploitation of State and local tax-exempt bonds. Regardless of the Committee's views on the propriety of funding shopping centers or industrial parks with such bond issues, local government must be able to continue to use such financing for essential governmental services, and should be free to decide the most efficient means of providing such services without worrying about running afoul of the one-percent test.

II. Arbitrage Restrictions

The President's proposal would extend additional arbitrage restrictions, similar to present law rules applicable to industrial development bonds, to all tax-exempt bonds. All bond issuers would be required to "rebate" to the United States all arbitrage profits on nonpurpose obligations. Additionally, the proposal would change the calculation of bond yield by disregarding all costs of issuance such as underwriters' discount, fees, and so on, thereby increasing the amount defined as arbitrage.

Arbitrage, in this context, simply means the differential in interest rates payable on tax-exempt as opposed to taxable securities. Obviously, investors are willing to accept a lower yield on tax-exempt securities, since their interest income will not be offset by federal income tax payable thereon. The purpose of the arbitrage rules is to prevent issuers from issuing debt at the lower tax-exempt rate in order to invest the proceeds at higher market rates.

We would argue that the arbitrage provisions of the Code and regulations have already done away with transactions engaged in for the purpose of generating arbitrage, and therefore already prohibit such abusive transactions. Further, we agree that the current policy to prevent arbitrage-motivated transactions is a good one in that it strikes a reasonable balance between federal and local interests. But the President's proposal goes far beyond the prevention of abuse and seeks to prevent all arbitrage, whether intentional or not.2/

This proposal will prevent local governments from using their financial resources in a sound, business-like manner. As long as any tax exemption for government bonds exists, there will be a differential in rates between tax-exempt and taxable obligations, and hence arbitrage. It is simply sound business practice to issue bonds to cover costs of a project at one time, particularly if there is a reasonable expectation that interest rates will rise; and it would be irresponsible and unjustifiable for a public official to invest the resulting proceeds at anything less than market interest rates, while the project approaches completion. In fact, many state and local laws prohibit the undertaking of such projects

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2/ In addition, the proposal places additional restrictions on current law temporary period rules. All arbitrage earned during the temporary period would be rebated to the United States, and additionally, the temporary period would be limited in that the issuer would be required "to spend a significant part of the proceeds within one month and spend all proceeds . . . . within three years of issuance." Even if this rule were otherwise retained, it should be clarified to define "spend" as meaning to obligate contractually, not as actual disbursement. And it is unrealistic to assume that all projects, particularly large and complex construction projects, can be completed within three years. In such cases, the proposal is obviously unfair, since an issuer would be locked into a project without the insurance that additional necessary financing would be forthcoming three years down the road, or that such financing would be affordable even if available.

until financing sufficient to fund the entire project is assured. In addition, the use of such non-abusive arbitrage is beneficial in that the bond issue can be slightly smaller.

In such non-abusive situations, there should be no reason for the federal government to confiscate the amount realized. After all, it is the local government which bears the risk of the financial markets, and the local government which has generated the proceeds in the first place.

Finally, the proposed change in calculating arbitrage presents serious problems. In requiring that issuance costs be ignored for purposes of determining bond yield, the President's proposal is in effect imposing a direct tax on the tax-exempt issuer. Since such costs would be included in bond "proceeds", even though not available to the issuer, they will result (on paper) in a lower bond yield, which in turn results in a greater spread between bond yield and investment yield. Thus, there will be additional "arbitrage" under the proposal's definition, even though such arbitrage would exist solely on paper. Therefore, the issuer would really lose money on the transaction, since it would have to rebate more arbitrage to the federal government than it actually earned. In effect, the federal government would be taking a cut off the top of every tax exempt bond issue, taxing the issuer for more than the income actually generated by the transaction. This result need only be stated to demonstrate its inequity.

Surely this rule would not make for wise policy, even if it could pass Constitutional muster.

III. Prohibition of Advance Refundings

In order to avoid paying more interest than necessary when rates fall, government issuers quite rationally utilize "advance refunding." This is nothing more than issuing new bonds at the lower market rate and investing the proceeds, usually in United States government bonds; payments from these United States bonds are used to make payments on the old bonds. In effect, this is the same as issuing new bonds and using the proceeds to call the old, higher-interest bonds; but since the market demands that the bonds bear a fairly lengthy call protection (10 years is typical) this latter method often cannot be used. If the issuer wished to be able to call the bonds at its option, market forces would require a premium in the form of higher interest rates on those bonds. In addition, advance refunding allows issuers to stretch out repayment schedules, and sometimes to avoid restrictive covenants connected with the old issue.

The President's proposal would forbid all advance refundings. The stated rationale behind this policy is to curtail the volume of tax-exempt issues. In practice, however, it will mean that government issuers will be unable to respond rationally to market interest fluctuations, and hence will be forced to expend more on borrowing costs than otherwise necessary. In other words, local governments will be foreclosed from making the same rational decision to refinance their debts that both private investors and the Federal government have available. Such a policy will result either in decreased local government services or increased local taxes, and will prevent states and localities from utilizing sound financial management practices.

Finally, even if the proposed elimination of advance refundings were adopted, it should be prospective, applying only to bonds issued after the effective date of the statute. This will enable public issuers to determine the appropriate call protection period for the bonds issued, taking into consideration increased costs associated with shorter call protection periods. This opportunity is of course unavailable for bonds already issued under the assumption that advance refunding would be available; therefore, to apply the rule to prior issues would be grossly unfair.

CONCLUSION

The President's proposals concerning tax-exempt bonds will seriously impact state and local governments. While there may be abuses which must be curbed, these proposals (particularly the one-percent rule) extend far beyond any abuses, and will impact directly and catastrophically upon financing for the very type of fundamental governmental services which no one would argue should be curtailed.

In effect, the inadvertant results of these proposals seems to be that local governments are to be treated as just another special interest which must be disciplined. But, far from being a foe to be vanquished, State and local governments are a valuable partner to the federal government, with both striving for the same goal -- the general health and well being of our common constituency, the citizens of the United States.

This basic goal can best be met by each partner performing the functions for which it is best suited, utilizing those tools most particularly designed to effect those functions. Tax-exempt financing is a long established, efficient mechanism which enables us to meet our duties to our citizens. I urge you not to lose sight of these principles. We should not let a well-meaning attempt to curb abuses interfere with and even destroy the ability of State and local governments to provide fundamental services for their citizens.

STATEMENT FOR THE RECORD

by

Jean Olson, President

Minnesota School Boards Association

on

TAX REFORM

before the

COMMITTEE ON FINANCE
U.S. Senate

July 30, 1985

Mr. Chairman, members of the committee, I am Jean Olson, an elected member of the Duluth School Board and president of the Minnesota School Boards Association. Thank you for the opportunity to testify as to the current state of education in Minnesota and the impact on education of the proposed federal tax reforms.

Minnesota enjoys a national reputation for excellence in education. Our governors, legislators, and citizens have a tradition of strong commitment to public K - 12 education. Taxes and education were the top priorities of the 1985 legislative session. In spite of a significant tax cut, the next biennium will see an increase in spending for K - 12 education, with 24% of the state budget allocated for education. Citizen polls give schools high grades and indicate a willingness to spend money for education.

In the early 1970's, Minnesota established a school finance formula designed to reduce reliance on local property taxes, based on the belief that a child's education should not depend on the wealth of a local district. This increased reliance on state funding has also made schools vulnerable to fluctuations in the state economy. For example, in 1981 a shortfall in state revenues was passed onto local school districts. Duluth, that year, in an effort to cut six million dollars from our budget (14% of the total), closed eight schools and laid off 200 employees.

These cuts were necessary in spite of continuing efforts to cut expenditures and to operate more efficiently. State law demands that our meetings and records are open to the public. We are prohibited from deficit spending. Levy limits are set by the state; local districts may, with voter approval, adopt levies in excess of those limits. Voter approval is also necessary for major capital expenditures requiring bonding.

Increased costs and increased demands for services indicate a continued need for revenue. We are understandably concerned that proposed tax reforms be evaluated to assess their impact on the ability of the state and local districts to provide stable and adequate funding of education. We are especially concerned about the proposal to eliminate the deduction of state and local taxes on federal income tax returns.

Clearly this proposal has greater impact on high-tax states. It is important to remember, however, that high taxes pay for a high level of services. Minnesotans, who are willing to support good schools, maintain good roads, and to care for their neighbors, should not be unfairly penalized by the federal government.

While the loss of deductibility would not directly affect revenues available for education, we are concerned that in the long run revenues could be affected. First, taxpayer pressure at the state level could impact state aids to education. If the loss of state aid were cushioned by increases in local levies, we could see further retreat to the funding of education based on wealth of local districts. Because voters must give referendum approval to excess levies for bonding for major capital improvements, it is very likely that voter frustrations with taxes in general would be expressed by refusing to approve school referenda.

Our concern, then, is for the indirect effect that the loss of deductibility could have on education revenue. A well-educated public is critical to our economy and essential to our democratic form of government. If public education is to be the responsibility of state and local government, then we must retain the authority to obtain the revenue to provide good schools. While tax reform proposals need to be evaluated on the basis of their overall impact on the economy and on the taxpayer, we ask that you continue to carefully assess the long term impact on state and local government.

Jean Olson
2029 E. Superior Street
Duluth, MN 55812

July 25 Rec M

MISSOURI SCHOOL BOARDS ASSOCIATION
1809 Vandiver Drive, Columbia, Missouri 65202-1983 • Telephone: 314/474-8591 • 1-800-221-MSBA

Statement for the Record

by

THE MISSOURI SCHOOL BOARDS ASSOCIATION

on

TAX REFORM

for the

FINANCE COMMITTEE
U.S. Senate
215 Dirksen Senate Office Building

August 7, 1985

Submitted by
Dr. Carter D. Ward
Executive Director, MSBA

STATEMENT FOR THE RECORD

The Missouri School Boards Association, an organization of 377 school boards which are responsible for the education of more than 92% of the public school children in the state of Missouri, is presenting this statement to express our concerns about the impact several of the components of the President's Tax Simplification Proposal will have on public school districts in Missouri.

Repeal of the Deduction for State and Local Taxes

MSBA endorses the concept that state and local tax deductibility is financially beneficial to a sound public school system. If state and local taxes are no longer deductible, an average of $535.00 will be lost by the 36.3% of taxpayers in Missouri who itemize deductions. We believe this tax increase is opposed by the people of Missouri and the result will be a resistance by taxpayers to any increases in taxes at the local level which are needed by public school districts. In addition, the number of adults with children in grades K-12 is relatively small, and the deductibility of state and local taxes provides an incentive for the other taxpayers in a community who are not parents to vote for local tax increases and bond issues to fund local public school district budgets and capital improvement projects.

Restriction of the Availability of Tax-Exempt Bonds to States and Localities

The issuance of tax exempt bonds is especially important for school districts in Missouri that need capital improvement projects. If bonds cannot be issued as tax-exempt, they will have to be issued at an interest rate high enough to make them attractive to investors. This will further restrict local public schools in providing a quality educational program. Either taxes will have to be raised or programs will have to be cut to pay for the additional bond retirement cost.

Rebate to the United States of All Arbitrage Coupled with Termination of Early Issuance of Tax-Exempt Bonds

The ability to borrow money in the form of tax anticipation notes is an important procedure school districts in Missouri use to purchase curriculum materials when needed, take advantage of vendor rebates, etc. and to avoid maintaining large cash balances which are an additional cost to taxpayers. The Missouri General Assembly recently passed a bill which allows the Missouri Health/Education Facilities Authority (MoHEFA) to issue tax anticipation notes to school districts at low or no interest which will mean a direct savings to the taxpayer and will allow more funds to flow directly to schools' educational programs. These low interest notes are possible because of legal arbitrage. If all arbitrage must be rebated to the federal government, school districts will have to pay additional interest on these notes, another cost to the taxpayer.

Summary

We view the above components of the administration's Tax Simplification Proposal as a significant shift in the attitude of the federal government towards local government. The federal government would no longer help finance state and local governments through the use of tax credits, and we foresee problems with the development and stability of local taxing structures. In addition, removing tax exempt incentives will further hinder the ability of school districts to provide local funds for their budgets and capital improvement projects.

We believe Missourians want tax reform. But we believe that they are interested in closing loopholes to make the tax system fair, not in eliminating deductions and exemptions which would result in raising local taxes, decreasing the power of local governments, and impairing a quality educational program in the public schools.

STATEMENT FOR THE RECORD

on behalf of

NEW YORK STATE SCHOOL BOARDS ASSOCIATION

on

TAX REFORM

before the

COMMITTEE ON FINANCE

U.S. Senate

July 29, 1985

President Reagan submitted a comprehensive tax reform proposal to the Congress on May 29, 1985. The President's proposal, submitted "to increase growth, reduce complexity, and make the system more fair" seriously threatens existing state and local funding sources for elementary and secondary schools. Among the changes recommended in the President's plan is the elimination of the deductibility of state and local taxes on federal tax returns. Taxes currently deductible include:

- State and local real property taxes.
- State and local personal property taxes.
- State and local income taxes.
- State and local general sales taxes.

The repeal of deductibility may end more than half of the Federal government's assistance to elementary and secondary education. The U.S. government provided $8.6 billion in direct aid in 1984-85. As a percentage of all non-federal revenues for elementary and secondary schools, direct federal aid accounted for 6.5 percent of total costs. A November 1983 study prepared for the U.S. Department of Education reports that for the 1980 calendar year "8.4 percent of the so-called nonfederal share of elementary-secondary education . . . was actually financed by the Federal government through the tax deduction mechanism".

Education Is A Major Benefactor of Tax Deductibility

The President's proposal for the elimination of the deductibility of state and local taxes on federal income tax returns would generate $149 billion in revenue through 1990-91, according to Treasury Department estimates. The 1983 study completed for the U.S. Department of education showed that 32 percent of the tax revenue saved by taxpayers in 1980 as a result of deductibility was on state and local taxes imposed for the benefit of public elementary and secondary schools.

According to the 1983 study, "taxpayers claimed $69.4 billion in itemized deductions on their 1980 individual federal income tax returns for taxes paid to state and local governments, thereby reducing their income taxes by $22.55 billion. Of that $22.55 billion tax saving to the individuals (or revenue loss to the federal government), approximately $7.32 billion is attributable to taxes for elementary and secondary education and $9.55 billion to taxes for all levels of public education combined."

Comments on President's Position on Deductibility

The following comments on President Reagan's tax plan refer to the summary and general explanation submitted to the Congress on May 29, 1985 in a special report, The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity.

Portability of Education Benefits. Arguments advanced for the President's plan would suggest that no benefits are derived by one state from education programs conducted by another. The President's report to the Congress states, "The deduction for state and local taxes may . . . be regarded as providing a subsidy to state and local governments, which are likely to find it somewhat easier to raise revenue because of the deduction. A general subsidy for spending by state and local governments can be justified only if the services which state and local governments provided have important spillover benefits to individuals in other communities. The existence of such benefits has not been documented."

Analysis of the long-standing migration patterns of American adults highlights the weakness of the rhetoric used in support of the President's proposal. Many graduates of the New York State public school system are now taxpayers in other states. And graduates of public school systems in the other 49 states and the District of Columbia currently reside in New York State.

A Multi-State Issue. The May 1985 report to the Congress suggests that taxpayers in New York State are the principal beneficiaries of the existing provisions for deductibility of state and local taxes. The November 1983 report prepared for the U.S. Department of Education shows, however, that elementary and secondary education revenues in six states outside of New York could be more adversely affected by the repeal of the current deductibility provisions for state and local taxes, as noted below in the next table. Within 29 states and the District of Columbia, 1980 education tax expenditures were estimated to represent an amount equal to more than 6 percent of the combined federal, state, and local outlays for elementary and secondary schools.

Education tax expenditures for elementary and secondary schools, which equalled $7.3 billion in 1980, represent Federal income tax savings to itemizers from state and local property, income, and sales tax revenues allocated for public schools. This amount is equal to 7.8 percent of the approximately $94 billion spent by elementary aned secondary schools in 1980. That 7.8 percent is greater than the 6 percent share of public school expenditures provided by the federal government. The following table lists those states in which 1980 education tax expenditures exceeded six percent of overall outlays:

1980 EDUCATION TAX EXPENDITURES
AS A PERCENT OF
ELEMENTARY-SECONDARY EDUCATION OUTLAYS

Rank	State	Percent
1	California	11.9%
2	Maryland	11.7
3	New Jersey	11.6
4	Minnesota	11.1
5	Connecticut	10.8
6	Colorado	10.6
7	New York	10.5
8	Michigan	10.3
9	Massachusetts	9.8

10	Delaware	9.7
11	Virginia	9.1
12	Illinois	8.5
13	Hawaii	8.5
14	Wisconsin	8.1
15	Rhode Island	8.0
16	Georgia	8.0
17	Utah	7.7
18	District of Columbia	7.6
19	Oregon	7.6
20	North Carolina	7.2
21	Idaho	7.1
22	New Hampshire	7.1
23	Pennsylvania	7.1
24	Vermont	7.0
25	Kansas	6.7
26	Missouri	6.6
27	Iowa	6.5
28	Arizona	6.3
29	Oklahoma	6.1
30	South Carolina	6.1

Source: Barro, Stephen M., *Federal Tax Expenditures for Education: The Deductibility of State and Local Taxes*, a report prepared for the U.S. Department of Education under contract number 300-83-0211, Decision Resources Corporation, Washington, D.C., 1983.

Balance of Power Within the Federal System. Many commentators have noted that state and local taxes have been deductible expenditures since the Federal Congressional policy statement on the desirability of providing funds to encourage state and local governments to raise money to solve problems at the local level. It also constitutes a recognition that support for local services through the use of tax *deductibility provides the most cost effective form of Federal grants-in-aid*.

The President's proposal rejects the historic policy position on balance within the Federal system. The May 1985 report from the Office of the President contends,

> "The 'tax on a tax' argument suggests that amounts paid in state or local taxes should be exempt from Federal taxation because they are involuntary and state or local taxpayers receive nothing in return for their payments. Neither suggestion is correct. State and local taxpayers have ultimate control over the taxes they pay through the electoral process and through their ability to locate in jurisdictions with amenable tax and fiscal policies."

Although one might reject the administration's assumptions, they do raise an interesting question of public policy. Assuming the Administration is correct, does it thus envision, and indeed promote, a new type of frontier society in which citizens with the **least** capacity to relocate are concentrated in a few areas that no longer have the resources to provide support services? That indeed is a major implication of this proposal.

Consequences of Loss of Deductibility for Education

We, of course, are vitally interested in what happens to the quality of public education if this important form of federal assistance (deductibility) is removed. You should be concerned as well, as a well educated populace is the backbone of our society.

The Treasury plan to eliminate deductibility could have serious negative impact upon school boards' capacity to raise the revenues necessary for good quality public education.

The issue for the school boards of this nation is the impact on the individual taxpayer. What would be the attitude of the individual property taxpayer when he/she regards the school tax bill, with no opportunity to offset it on the income tax?

Presently, some of the sting from the local real property tax (also from State and local sales and income taxes) is removed because it can be deducted in federal income tax calculations. School districts are heavily dependent on the property tax, which pays the largest share of public school costs.

It is reasonable to expect:

- heavy pressure to cut school property tax rates, and
- greater resistance to school budgets by the voters.

Most school districts submit their proposed budgets to the voters for approval. The voters reject those budgets when they consider them too high, or when they don't believe they are getting the right kind of education for their tax dollar.

Even this year, when voters were in a mood to be supportive, 11.1 percent of the school district budgets were defeated. In 1978, 33.7 percent of the budgets went down. Imagine, if you will, how voters will react to proposed school budgets when their school taxes are no longer deductible on their federal income tax returns!

Perhaps the most serious impact of loss of deductibility would be the postponement or abandonment of the current serious efforts to improve educational quality by enriching school programs and improving teacher capabilities and compensation, efforts that require substantial commitment of State and local monies.

Extra Burden on the Taxpayer

We have done some arithmetic and we have estimated, for 18 states, how much more federal taxes the average taxpayer who itemizes deductions would pay if the deductibility of state and local taxes was eliminated.

ADDITIONAL FEDERAL TAXES OWED
BY THE AVERAGE TAXPAYER
IF DEDUCTIBILITY IS ELIMINATED

State	Added Federal Taxes in 1987
Connecticut	$1,040
Delaware	1,294
Georgia	768
Hawaii	1,049
Illinois	846
Maryland	1,208
Massachusetts	1,246
Michigan	1,075
Minnesota	1,132
New Jersey	1,129
New York	1,646

Oregon	908
Rhode Island	1,095
Virginia	958
Wisconsin	1,128
Pennsylvania	873
California	1,100
Colorado	777

Will that have an impact on school budgets? You bet it will!

One School District

In closing, it may be helpful to the members of this Committee to read the words of one school superintendent on this subject. He wrote his congressman, and here is what he said:

"I am the Superintendent of a small suburban district in Rockland County whch serves a community of about 12,000 middle-class residents, many of whom moved to the area to provide the finest educational opportunities that they could afford. Although the cost of such educational services has increased over the last two decades and although the burden this has produced on them is not inconsiderable, South Orangetown residents continue to support a public educational program that they think makes sense for their children and which produces some fairly impressive results for the cultural and economic well-being of the area and the state.

"The investment they have made in a better life for their families appears under threat by the tax reform measures proposed by the present administration. If, as proposed, that reform includes eliminating the deduction from federal tax liability of local taxes like those which support South Orangetown's schools, our parents - and hundreds of thousands like them across the state - will find it increasingly difficult to generate support for school spending at even the maintenance level. Even if these school-support types remain steadfast and continue to vote additional expense upon themselves, they will never be successful in the effort they are sure nonetheless to make to convince the 70% majority of most suburban districts who have no kids in school to do the same."

Please keep his words in mind as you consider the issue of the deductibility of state and local taxes.

TESTIMONY OF FRANK J. MACCHIAROLA
PRESIDENT
NEW YORK CITY PARTNERSHIP

BEFORE THE
UNITED STATES SENATE
COMMITTEE ON FINANCE
Hon. Bob Packwood, Chairman

July 25, 1985

I am pleased to have this opportunity to express the concerns of the New York City Partnership and the New York Chamber of Commerce and Industry about the proposal to eliminate the Federal deductibility of state and local taxes. I agree with the President that we need to reform and simplify our tax code. It is too complex and unwieldly for anyone but accountants and tax experts. But when the President introduced his Treasury II tax plan, he declared that what was necessary to secure its acceptance was a second American revolution. I suggest that one feature of the proposal, the elimination of the federal deduction for state and local taxes, is not revolutionary. It is but counter-revolutionary.

What the American patriots fought for at the Battle of Saratoga and what they crafted at the Constitutional Convention in Philadelphia was a government of balance. It seems extraordinarily ironic that a proposal from a President who has spoken so eloquently about restoring proper balance in the federal system now threatens that balance. Certainly I do not think the President intends such a disruption, but inadvertent though it may be, the result will be the same.

I emphasize these points about the issue of deductibility because so much emphasis has been placed on which states gain and which states lose and which states gain under what circumstances. Of course, these are not irrelevant considerations but they miss the fundamental question. Federal deductibility of state and local taxes has been more than a policy choice; it has been a vital principal of our Federal system. It has guaranteed the authority of states and localities to make decisions appropriate to local needs, without fear that their residents will have those payments subjected to taxation by the Federal government.

Even before the 16th Amendment authorized the collection of Federal income tax in 1913, there was allowance for the deduction of state and local taxes. The first income tax ever imposed, during the Civil War, made state and local taxes deductible. Those were conscious choices about balanced government, and should not be set aside easily.

The deduction for state and local taxes is the largest single deduction taken by the nation's taxpayers, and one of the few which benefits middle class people. Eighty-seven percent of taxpayers who take the deduction have incomes less than $50,000, and it is claimed on 33 million returns filed by nearly 58 million people. Further, the deduction benefits both the so-called "low tax" as well as the "higher tax" states.

It has also been argued that low-tax states have been subsidizing high tax states through deductibility. But the facts belie this argument. While over half of the $40 billion in estimated revenue gained by eliminating the deduction would be raised in just sixteen states, the 108 million residents of those same sixteen states contribute over 50% of all the personal income tax revenue received by the Treasury. The truth is that nine of the sixteen states send more money to Washington than they get back in Federal grants. The money which funds public works and grant assistance represents, to my mind, a source of national strength, not an inequitable regional subsidy.

I do not need to reach the threshold of what is good for New York State in determining my position on this issue, but I know that the elimination of deductibility would be unfair and disruptive to that State. As president of the New York City Partnership , an organization committed to the vitality of New York City and New York State, I am opposed to any tax plan which would endanger the State's economic health or that of any other state. The elimination of deductibility will have a major impact on schools and education, and on the credit ratings of local governments.

Another effect will be to reduce services provided by state and local governments, and generate pressures for the Federal government to provide the services which might otherwise have been supplied by regional authorities. The indications also point to lowered property values without deductibility, which may stimulate the migration of businesses and taxpayers into other, lower-taxed areas. The competitive disparities which already exist between states would only be intensified, and low-tax regions might well be inundated with greater numbers of "tax refugees" than local infrastructure and support systems could manage.

I strongly urge the members of Congress to maintain the Federal deductibility of state and local taxes. Deductibility is based on fundamental principles which have served the entire nation well. We should not abandon them now.

Thank you.

July 25 Rec P

TESTIMONY BY

ROBERT D. VAN BROCKLIN

DIRECTOR OF GOVERNMENT AFFAIRS

CITY OF PORTLAND, OREGON

BEFORE THE

UNITED STATES SENATE COMMITTEE ON FINANCE

THE HONORABLE ROBERT PACKWOOD, CHAIRMAN

PRESIDENT REAGAN'S TAX REFORM PROPOSALS: EFFECTS ON STATE AND LOCAL GOVERNMENT

JULY 25, 1985

Mr. Chairman and Distinguished Members of the Committee, I am Robert Van Brocklin, Director of Government Affairs, for the City of Portland, Oregon. On behalf of Mayor J. E. "Bud" Clark and the members of the Portland City Council thank you, Mr. Chairman, for the opportunity to review the City's analysis of and concerns regarding President Reagan's Tax Reform Package. While the Administration's plan contains many recommendations that would impact Oregon residents and businesses I will confine my remarks today to the proposals that would, if enacted, affect state and local governments in Oregon. In particular, I will address the following recommendations for reform currently under consideration by the Congress:

- The proposed elimination of the deduction of state and local income taxes;
- The proposed elimination of the deduction of other state and local taxes except those incurred in an income producing activity;
- The proposed elimination of the tax exempt status of so called "private purpose" bonds;
- The proposed elimination of legal arbitrage on all tax exempt bonds;

- THE PROPOSED ELIMINATION OF ALL ADVANCE REFUNDINGS;
- THE PROPOSED ELIMINATION OF THE DEDUCTABILITY OF MUNICIPAL BOND HOLDING COST FOR COMMERCIAL BANKS;
- THE PROPOSED REDUCTION OF THE MARGINAL TAX RATES ON PERSONAL INCOME TAX;
- THE PROPOSED CHANGES IN FEDERAL REPORTING REQUIREMENT ON ALL TAX EXEMPT BOND ISSUANCES;
- THE PROPOSED TERMINATION OF THE ENERGY CONSERVATION RENEWABLE RESOURCE TAX CREDIT; AND
- THE PROPOSED TERMINATION OF THE HISTORIC REHABILITATION TAX CREDIT.

IN ADDITION, REFERENCE IS MADE TO OTHER KEY PROVISIONS IN THE REFORM PACKAGE INCLUDING RAISING THE ZERO BRACKET AMOUNT; REDUCING THE NUMBER OF TAXABLE INCOME BRACKETS AND CORRESPONDING RATES; RAISING THE PERSONAL EXEMPTION AMOUNT; AND ELIMINATING THE SECOND EARNER DEDUCTION FOR WORKING COUPLES.

STATE AND LOCAL TAX DEDUCTABILITY

The President's Tax Reform Plan recommends the complete elimination of the deduction of state and local income taxes. Further, it calls for the elimination of other state and local taxes unless they are incurred in income producing activity.

Enactment of these proposals would dramatically effect the provision of state and local governmental services; reduce property values; and diminish bond values in Oregon. In addition, elimination of the deduction of state and local taxes from the federal return would radically change the historic relationship that has existed between the federal government and state and local government based on principles of "federalism" and reciprocal immunity. In introducing this revision, the Administration has failed to distinguish the historic role of the state and local deduction not as a tax shelter, but as a fundamental part of our federal system. The deductability of state and local taxes has been a part of the United States income tax system since its inception in 1913.

More American taxpayers take the federal deduction for state and local taxes than any other deduction. Nationally, over 33 million households take the deduction. This is more than for the charitable deduction (30.5 million households) or the home mortgage deduction (24.5 million households).

In Oregon, according to a recently published research report by the Oregon State Department of Revenue, of the 990,194 federal tax returns filed in 1983, 422,164 deducted state income taxes. This represents 42.6% of the total returns filed. The average amount deducted was $2,059.

Loss of the deduction could be particularly detrimental to middle income and lower income taxpayers. Under the President's proposal as submitted, many middle income families will actually experience a tax increase due to the loss of deductability. According to the Oregon Department of Revenue's Research Report, the loss of the deduction of state and local taxes combined with the loss of the second earner deduction for working couples could result in net increases in federal tax liability for many middle income taxpayers in Oregon, even given the proposed adjustment in the tax brackets and the reductions in tax rates.

Elimination of the deduction of state and local taxes may also adversely impact lower income taxpayers. If the state and local deduction is eliminated, state's with comparatively progressive tax structures would face increasing pressure to move toward more regressive tax bases. Such systems of taxation shift a greater share of the tax burden to those least able to pay their taxes. While a majority of our income earners do not itemize, and therefore cannot deduct state and local taxes, they do pay taxes. Their relative tax burden is, therefore, a function of the nature and progressivity of a given state or local tax

SYSTEM. THE CURRENT DEDUCTABILITY OF STATE AND LOCAL TAXES ALLOWS THE INDIVIDUAL STATES TO ACHIEVE A PROGRESSIVE AND EQUITABLE DISTRIBUTION OF TAX BURDEN AMONG THEIR POPULATION.

IN ADDITION TO THE POTENTIAL SHIFT IN RELATIVE TAX BURDEN, THE LOSS OF THE DEDUCTION FOR LOCAL TAXES COULD WELL LEAD TO A REDUCTION OF STATE AND LOCAL GOVERNMENTAL SERVICES AVAILABLE TO LOW INCOME CITIZENS. AS A CONSEQUENCE, ANY GAINS TO LOW INCOME WAGE EARNERS FROM CERTAIN PROVISIONS OF THE PRESIDENT'S PROPOSAL--SUCH AS THOSE FROM AN INCREASE IN THE ZERO BRACKET AMOUNT OR THE EARNED INCOME TAX CREDIT--COULD BE OFFSET BY CUTS IN STATE AND LOCAL SERVICES AND/OR POTENTIALLY HIGHER STATE AND LOCAL TAXES.

THE STATE AND LOCAL DEDUCTION ALSO BENEFITS THE ELDERLY, PERHAPS MORE THAN ANY OTHER DEDUCTION. NATIONALLY, THE STATE AND LOCAL DEDUCTION IS WORTH AN AVERAGE OF $2,798 TO THE ELDERLY WHICH IS MORE THAN THE CHARITABLE DEDUCTION ($2,116), THE MEDICAL EXPENSE DEDUCTION ($2,046), OR THE HOME MORTGAGE DEDUCTION ($1,939). BECAUSE MANY ELDERLY PEOPLE HAVE PAID OFF THEIR MORTGAGES, ELIMINATING STATE AND LOCAL TAX DEDUCTABILITY WILL TURN THEM INTO NON-ITEMIZERS, PRECLUDING THEM FROM DEDUCTING CHARITABLE CONTRIBUTIONS, MEDICAL EXPENSES, AND OTHER DEDUCTABLE EXPENDITURES.

IF THE DEDUCTION WERE ELIMINATED, THOSE TAXPAYERS WHO DEDUCT STATE AND LOCAL TAX FROM THEIR FEDERAL RETURN WOULD SUDDENLY FEEL

AN INCREASED IMPACT FROM STATE AND LOCALLY IMPOSED TAXES. IN OREGON, A HIGHER THAN AVERAGE PERCENTAGE OF TAXPAYERS ITEMIZE. THESE TAXPAYERS, WITH VERY FEW EXCEPTIONS, DEDUCT STATE AND LOCAL TAXES. BECAUSE THEY ARE SO NUMEROUS, THESE TAXPAYERS ARE ESPECIALLY LIKELY TO SUCCEED IN EFFORTS TO PRESSURE STATE AND LOCAL GOVERNMENTS TO CUT TAXES AND SERVICES.

IN OREGON, THE TAX SYSTEM WHICH FUNDS STATE AND LOCAL SERVICES PRIMARILY RELIES ON TWO TAX SOURCES: INDIVIDUAL AND CORPORATE INCOME TAXES AND THE PROPERTY TAX. RECENT STUDIES HAVE SHOWN THAT OREGON RANKS AMONG THE TOP FIVE STATES IN INCOME TAXATION AS A PERCENTAGE OF PERSONAL INCOME, AND AMONG THE TOP TEN STATES IN PROPERTY TAXES AS A PERCENTAGE OF PERSONAL INCOME. IN 1982 AND 1984, OREGON VOTERS NARROWLY DEFEATED PROPOSED CONSTITUTIONAL AMENDMENTS TO LIMIT AD VALOREM TAXES TO NO MORE THAN 1.5% OF ASSESSED VALUE. IN A TAX ENVIRONMENT SUCH AS OREGON'S, THE ELIMINATION OF THE DEDUCTION OF STATE AND LOCAL TAXES COULD INSURE THE SUCCESS OF A FUTURE PROPERTY TAX LIMITATION MEASURE. THE TWO MOST RECENT PROPERTY TAX LIMITATION MEASURES ON THE OREGON BALLOT, BALLOT MEASURE 3 IN 1982, AND BALLOT MEASURE 2 IN 1984, BOTH RECEIVED MORE THAN 49% OF THE VOTE. TWO PETITIONS HAVE ALREADY BEEN SUBMITTED TO THE OREGON SECRETARY OF STATE'S OFFICE THAT WOULD PLACE SIMILAR PROPERTY TAX LIMITATION MEASURES ON THE GENERAL ELECTION BALLOT IN 1986. MOST OREGON BUSINESS, LABOR, EDUCATION AND GOVERNMENT LEADERS ARE IN AGREEMENT THAT A PROPERTY TAX LIMIT WOULD SEVERELY UNDERMINE OREGON'S ABILITY TO MAINTAIN THOSE PUBLIC SERVICES NECESSARY TO INDUCE ADDITIONAL PRIVATE ECONOMIC INVESTMENT IN THE STATE.

ONE ARGUMENT WHICH HAS BEEN LEVIED IN DEFENSE OF ELIMINATING THE DEDUCTION IS THAT IT DISPROPORTIONATELY BENEFITS HIGH INCOME TAXPAYERS RESIDING IN HIGH TAX STATES. WHAT IS NOT CONSIDERED IN THIS ARGUMENT IS THAT RESIDENTS IN HIGH TAX STATES ALSO TEND TO PAY A GREATER SHARE OF THE FEDERAL INCOME TAX FOR EACH DOLLAR RETURNED TO THEIR STATE'S RESIDENTS. FURTHERMORE, WHILE THE RESIDENTS OF SOME STATES SAVE MORE THAN OTHERS FROM THE DECUCTION, RESIDENTS IN MANY STATES ALSO BENEFIT DISPROPORTIONATELY FROM FEDERAL EXPENDITURES.

IT HAS BEEN STATED BY TREASURY SECRETARY BAKER THAT ELIMINATION OF STATE AND LOCAL DEDUCTABILITY IS A FOUNDATION OF TAX REFORM. THIS IS TRUE ONLY IF ONE ACCEPTS THE UNDERLYING ASSUMPTION OF THE PRESIDENT'S PROPOSAL. IT IS NOT FAIR TO ASSERT THAT IF ONE DEFENDS THE DEDUCTABILITY OF STATE AND LOCAL TAXES ONE MUST BE OPPOSED TO TAX REFORM.

ELIMINATING THE DEDUCTION ALSO HAS SUBSTANTIAL NEGATIVE IMPLICATIONS FOR THE DELIVERY OF STATE AND GOVERNMENTAL SERVICES. IN EXCHANGE FOR A POTENTIALLY LARGER SHARE OF THE TAX BURDEN CREATED BY PRESSURE TO ADOPT MORE REGRESSIVE SYSTEMS OF STATE AND LOCAL TAXATION, MANY INCOME EARNERS WILL EXPERIENCE:

- POORER SCHOOLS FOR THEIR CHILDREN;

- CLOSED PUBLIC HOSPITALS;

- REDUCED POLICE AND FIRE PROTECTION FOR THEIR NEIGHBORHOODS;
- CUTBACKS IN THE ENFORCEMENT OF SAFE HOUSING CODES;
- UNREPAIRED STREETS;
- INFERIOR WATER, SEWER, AND OTHER SERVICE DELIVERY.

ACCORDING TO A RECENT REPORT, OREGON RESIDENTS RANK 17TH AMONG THE STATES IN GROSS FEDERAL TAX SAVINGS FROM STATE AND LOCAL TAX DEDUCTABILITY. IN OREGON, THIS RESULTS IN AN AVERAGE TAX SAVINGS PER ITEMIZING RETURN OF $725 PER YEAR.

IF DEDUCTABILITY IS ELIMINATED, THERE WILL BE GREAT PRESSURE BY THOSE WHO ITEMIZE TO REDUCE STATE AND LOCAL TAXES. TAXPAYERS WILL FACE LOWER HOME PROPERTY VALUES AND WILL BE ATTRACTED TO CONSIDER MIGRATION TO LOWER TAX COMMUNITIES. MIGRATION COULD OCCUR FROM CITY TO SUBURBS, OR ACROSS STATE LINES.

AS A RESULT, STATES AND LOCALITIES WILL FACE GREAT PRESSURE TO REDUCE TAXES AND RELATED SERVICES. THE EXTENT OF THE CUT IN SERVICES WILL DEPEND UPON THE POLITICS OF TAX REVOLTS IN EACH LOCALITY AND STATE. WHILE POLITICS CANNOT BE ACCURATELY FORECASTED, ESTIMATES OF SERVICE CUTBACKS RANGE FROM 7% TO 21% OF CURRENT SERVICES SUPPORTED BY STATE AND LOCAL TAXES. THE

CONSERVATIVE ESTIMATE COMES FROM THE CONGRESSIONAL RESEARCH SERVICE, WHICH HAS ESTIMATED A 15% CUTBACK.

ELIMINATION OF THE DEDUCTION WOULD ALSO HAVE A SIGNIFICANT IMPACT ON EDUCATION FINANCE. ACCORDING TO ONE ANALYSIS, NATIONWIDE, SPENDING PER PUPIL IN BASIC EDUCATION COULD DECLINE AS MUCH AS 20%. CUTBACKS IN STATE APPROPRIATIONS FOR HIGHER EDUCATION ARE ALSO LIKELY. THIS WOULD COME AT A TIME WHEN EDUCATION IS INCREASINGLY CENTRAL TO CREATING ECONOMIC OPPORTUNITY AND PROSPERITY IN STATES LIKE OREGON.

IN ADDITION, THERE IS ALSO GROWING CONCERN IN THE FINANCE COMMUNITY THAT MUNICIPAL BOND INVESTORS WOULD BE ADVERSELY IMPACTED BY THE EFFECTS OF ELIMINATING DEDUCTIBILITY. FOR EXAMPLE, MERRILL LYNCH CONCLUDES IN A RECENT REPORT THAT THERE COULD BE "SIGNIFICANT CREDIT DETERIORATION" OF MANY STATE AND LOCAL BONDS AS A CONSEQUENCE OF THE ELIMINATION OF STATE AND LOCAL TAX DEDUCTABILITY. THE REPORT STATES THAT:

- ELIMINATING DEDUCTABILITY MAY BE A CATALYST FOR NEW "TAX REDUCTION" POLITICAL MOVEMENTS IN THE STATE;

- NOT JUST "HIGH TAX" STATES WILL BE VULNERABLE;

- ALL STATE CREDITS WOULD BECOME WEAKER BECAUSE THE STATES WOULD LOSE FLEXIBILITY IN INCREASING INDIVIDUAL INCOME TAXES;

- THESE CREDIT CONCERNS ARE IMMEDIATE AS WELL AS LONG-TERM;

- SCHOOL BUDGETS APPEAR THE MOST VULNERABLE TO CUTBACKS;

- RATING DOWNGRADES BY MOODY'S AND STANDARDS AND POOR'S CAN BE EXPECTED FOR THOSE CREDITS MOST EFFECTED.

AS YOU KNOW, ANY REDUCTIONS IN CREDIT RATINGS TO MUNICIPALITIES OR STATES WILL COST THE BORROWER, HENCE THE CITIZENS OF THOSE COMMUNITIES OR STATES. IN SHORT, BORROWING COSTS PAID BY LOCAL TAXPAYERS WOULD RISE. THIS HAPPENS BECAUSE ELIMINATING DEDUCTABILITY REDUCES THE ABILITY OF THE STATE OR LOCALITY TO RAISE TAX REVENUES TO SECURE THE BONDS. ACCORDINGLY, INVESTORS WOULD DEMAND A HIGHER INTEREST PAYMENT IN RETURN FOR THE HIGHER RISK. BECAUSE OF THE LARGE VOLUME OF BONDS ISSUES, EXTRA INTEREST COSTS OF EVEN A FEW BASIS POINTS PER YEAR CAN ADD SIGNIFICANTLY TO STATE AND LOCAL BURDENS.

FINALLY, ELIMINATING DEDUCTABILITY GREATLY INCREASES THE ATTRACTIVENESS FOR TAXPAYERS, ESPECIALLY THOSE HIGHER-INCOME WAGE EARNERS, TO MIGRATE TO A LOW TAX REGION. AS AN EXAMPLE, A PORTLAND COUPLE WITH $100,000 OF ANNUAL INCOME NOW PAYS APPROXIMATELY $5,000 IN STATE AND LOCAL TAXES (OFFSET BY DEDUCTABILITY) COMPARED TO ONLY $1,000 A COUPLE WOULD PAY IN SEATTLE, WASHINGTON. IF DEDUCTABILITY WERE ELIMINATED, THE

PORTLAND COUPLE WOULD PAY APPROXIMATELY $9,600 IN THESE TAXES, COMPARED TO ONLY $2,100 IN SEATTLE. HENCE, ELIMINATING DEDUCTABILITY INCREASES THE INCENTIVE TO MIGRATE FROM PORTLAND TO SEATTLE FROM $3,900 TO $7,500 ANNUALLY. IN ADDITION, ELIMINATING DEDUCTABILITY WOULD CREATE SIGNIFICANT INCENTIVES TO MIGRATE WITHIN STATES, FOR EXAMPLE FROM CENTRAL CITIES TO SUBURBS.

DEDUCTABILITY CURRENTLY REDUCES THIS DISPARITY, AND REDUCES THE INCENTIVE TO MIGRATE. WITHOUT DEDUCTABILITY, CENTRAL CITIES AND THEIR SUBURBS WOULD BE FORCED TO ENTER INTO RUINONS COMPETITION TO CUT TAXES OR LOSE RESIDENTS, PARTICULARLY HIGH INCOME PEOPLE.

IN SUMMARY, THE FEDERAL DEDUCTION FOR STATE AND LOCAL PROPERTY, INCOME, AND SALES TAXES IS ESSENTIAL TO THE ECONOMIC WELL BEING OF LOCAL COMMUNITIES. THE DEDUCTION FOR STATE AND LOCAL TAXES HAS BEEN PART OF THE TAX CODE SINCE 1913 WHEN THE FIRST FEDERAL INCOME TAX WAS ENACTED. THE PURPOSE OF THE DEDUCTION FOR STATE AND LOCAL TAXES IS TO PROTECT INDIVIDUALS FROM DOUBLE TAXATION OF THEIR INCOMES. THE FINANCIAL HEALTH OF THE STATE OF OREGON, THE CITY OF PORTLAND, OTHER LOCAL GOVERNMENTS IN OREGON, AND MANY STATE AND LOCAL GOVERNMENTS THROUGHOUT THE COUNTRY WOULD BE COMPROMISED IF STATE AND LOCAL TAXES WERE NO LONGER DEDUCTIBLE FROM FEDERAL TAX RETURNS. MANY FAMILIES WOULD BE UNABLE TO AFFORD A HOME WITHOUT THE FEDERAL DEDUCTION FOR LOCAL PROPERTY TAXES, AND MANY BUSINESSES WOULD FLEE URBAN METROPOLITAN AREAS THAT MUST RAISE SUBSTANTIAL REVENUE TO SUPPORT NEEDED GOVERNMENT SERVICES. THE CONSEQUENCES OF THIS PROPOSAL ARE THAT AS THE TAX

BASE OF STATE OR LOCAL GOVERNMENT DECLINES, ESSENTIAL WELFARE, EDUCATION, HEALTH, AND INFRASTRUCTURE WOULD BE CUT. IN ADDITION, REPEAL OF THE DEDUCTION FOR STATE AND LOCAL TAXES WOULD TEND TO DEPRESS PROPERTY VALUES, PENALIZING FAMILIES WHO PURCHASED HOMES YEARS AGO BASED ON THEN CURRENT TAX LAW.

FINALLY, AT A TIME WHEN THE FEDERAL GOVERNMENT IS ATTEMPTING TO RETURN DOMESTIC PUBLIC SECTOR RESPONSIBILITIES TO STATE AND LOCAL GOVERNMENTS, THE FEDERAL GOVERNMENT WOULD BE SUBSTANTIALLY LIMITING THE CAPACITY OF SUBORDINATE LEVELS OF GOVERNMENT TO ASSUME THESE RESPONSIBILITIES BY ENACTING THE PROPOSALS CONCERNING DEDUCTABILITY AND PUBLIC FINANCE. IT IS INDEED IRONIC THAT AT A TIME WHEN THE ADMINISTRATION IS MAKING A CONCERTED EFFORT TO DECENTRALIZE DECISION-MAKING AND REDUCE GRANTS-IN-AID TO STATE AND LOCAL GOVERNMENT, THAT THE CENTRAL PRINCIPLE OF FEDERALISM IN THE FEDERAL TAX CODE--THE STATE AND LOCAL TAX DEDUCTION--WOULD BE PROPOSED FOR ELIMINATION. SUBORDINATE LEVELS OF GOVERNMENT IN THIS COUNTRY ARE UNALTERABLY OPPOSED TO THIS DRAMATIC ALTERATION OF THE RELATIONSHIP BETWEEN THE FEDERAL GOVERNMENT AND STATE AND LOCAL GOVERNMENT.

IN ACTING ON THE PRESIDENT'S PROPOSAL TO ELIMINATE THE STATE AND LOCAL DEDUCTION, WE WOULD URGE THAT THE COMMITTEE SERIOUSLY CONSIDER THESE IMPLICATIONS. ON BEHALF OF THE CITY, WE STRENUOUSLY OPPOSE THIS PROVISION IN THE PRESIDENT'S TAX PLAN.

STATE AND LOCAL GOVERNMENT FINANCE

THE PRESIDENT'S TAX REFORM PROPOSAL, IF ENACTED, WOULD EFFECT STATE AND LOCAL GOVERNMENT FINANCE IN SIX BASIC CATEGORIES:

- THE ELIMINATION OF TAX EXEMPT STATUS FOR ALL "PRIVATE PURPOSE" BONDS;
- THE ELIMINATION OF LEGAL ARBITRAGE ON ALL TAX EXEMPT BONDS;
- ELIMINATION OF ALL ADVANCE REFUNDINGS;
- ELIMINATION OF THE DEDUCTABILITY OF MUNICIPAL BOND HOLDING COSTS FOR COMMERCIAL BANKS; AND
- INCREASED FEDERAL REPORTING REQUIREMENTS.

OVER THE PAST TEN YEARS, THE MUNICIPAL BOND MARKET HAS INVOLVED BONDS DESIGNED TO MEET PUBLIC PURPOSES BY ASSISTING PRIVATE INDIVIDUALS OR ENTITIES. THESE BONDS HAVE INCLUDED:

- INDUSTRIAL DEVELOPMENT BONDS;
- HOUSING FINANCE BONDS;

- POLLUTION CONTROL BONDS;
- STUDENT LOAN FINANCING;
- HOSPITAL AND MEDICAL EQUIPMENT FINANCING.

THE CURRENT LAW RESTRICTS THE USE OF THESE MECHANISMS BUT STILL LEAVES THE DETERMINATION OF PUBLIC PURPOSE TO THE DISCRETION OF STATE AND LOCAL ELECTED OFFICIALS. THROUGH THESE FINANCING TOOLS, STATE AND LOCAL GOVERNMENTS ARE ABLE TO MEET THE NEED FOR JOB DEVELOPMENT, EDUCATION, HOUSING, ENVIRONMENTAL CONTROL, AND OTHER PUBLIC CAPITAL AND SERVICE REQUIREMENTS.

THE PRESIDENT'S PROPOSAL WOULD ELIMINATE THE TAX EXEMPT FINANCING FOR ALL OF THESE BONDS BY DEFINING THEM AS "PRIVATE PURPOSE" AND THEREFORE NOT ELIGIBLE FOR FEDERAL SUBSIDY IN THE FORM OF TAX EXEMPT RATES. THE MECHANISM FOR THIS DETERMINATION IS THE "1% RULE" WHICH STATES THAT IF MORE THAN 1% OF THE PROCEEDS OF A BOND SALE ACCRUE TO THE BENEFIT OF NON-EXEMPT PERSONS OR ENTITIES, INTEREST ON THE BONDS WOULD BE TAXABLE.

THE INTERPRETATION OF THIS RULE PROMOTED BY THE TREASURY DEPARTMENT WOULD EFFECTIVELY ELIMINATE TAX EXEMPT FINANCING FOR THE TYPE OF BONDS LISTED ABOVE, AND ALSO FOR STRICTLY MUNICIPAL GENERAL OBLIGATION AND REVENUE BONDS IF THEY FAIL THE 1% TEST. AS A RESULT, MANY PROGRAMS AND FACILITIES WHICH ARE CLEARLY

PUBLIC PURPOSE COULD LOSE THEIR TAX EXEMPT FINANCING. THESE INCLUDE BUT ARE NOT LIMITED TO DOCKS, AIRPORTS, SEWER LINES, WATER SYSTEMS, WHARFS AND OTHER PUBLIC FACILITIES AND SERVICES. THE RULE WOULD ALSO ELIMINATE TAX EXEMPT FINANCING FOR FACILITIES OWNED BY A NON-EXEMPT ENTITY BUT OPERATED TO THE BENEFIT OF PUBLIC OBJECTIVES. THESE "PUBLIC PRIVATE PARTNERSHIPS" ARE OFTEN USED IN SOLID WASTE, SEWER AND ENERGY FACILITIES.

THE PROPOSED RESTRICTIONS WOULD ALSO ELIMINATE THE ABILITY OF CITIES TO CONTRACT THE OPERATION OF THE FACILITIES WHICH ARE FINANCED BY TAX EXEMPT BONDS. THIS IS ACHIEVED BY LIMITING SUCH CONTRACTS TO ONE YEAR. APPARENTLY, THE THEORY IS THAT IF THE CONTRACT FOR OPERATION OF THE PUBLIC FACILITY EXTENDS BEYOND ONE YEAR, THE FACILITY IS EITHER NOT PUBLIC OR THE BENEFIT OF THE BONDS ACCRUES TO THE OPERATOR. IN MANY INSTANCES, THIS IS NOT THE CASE.

THE PRESIDENT'S PROPOSAL ALSO SUGGESTS ADDITIONAL ARBITRAGE RESTRICTIONS. THE PROPOSAL WOULD REQUIRE THAT ALL ARBITRAGE EARNINGS BE FORWARDED TO THE TREASURY, AND ALSO, THROUGH TECHNICAL ADJUSTMENTS, LOWERS THE ALLOWABLE YIELD. IN SOME CASES, THIS COULD RESULT IN ISSUERS ACTUALLY PAYING THE FEDERAL TREASURY OUT OF BOND PRINCIPAL. HENCE, IN CERTAIN CASES THE PROPOSAL MAY ACTUALLY IMPOSE AN INTEREST EARNINGS TAX ON LOCAL GOVERNMENTS.

CURRENT TAX LAW ALREADY LIMITS THE ABILITY OF LOCAL GOVERNMENTS TO EARN INVESTMENT "PROFITS" (ARBITRAGE) BY INVESTING FUNDS BORROWED AT TAX EXEMPT RATES AND TAXABLE SECURITIES. THE CURRENT REGULATIONS PROVIDE FOR THE INVESTMENT OF PROCEEDS FOR A REASONABLE "TEMPORARY PERIOD" WHICH ALLOWS FOR THE PLANNING, ENGINEERING, AND OTHER REQUIREMENTS OF A LARGE COMPLEX PROJECT. THE ABILITY TO INVEST PROCEEDS DURING THE TEMPORARY PERIOD AT TAXABLE RATES LOWERS THE AMOUNT OF BONDING REQUIRED AND THEREFORE THE DEBT SERVICE PAID BY LOCAL TAXPAYERS. THE TEMPORARY PERIOD WOULD BE 30 DAYS UNDER THE PRESIDENT'S PROPOSAL, WHICH WILL REQUIRE LOCAL GOVERNMENTS TO FINANCE MUCH OF THE INITIAL COST OF LARGE PROJECTS OUT OF OPERATING REVENUES SO THAT THE BOND PROCEEDS CAN BE EXPENDED DURING THE TEMPORARY PERIOD.

IN AN EFFORT TO LOWER THE TOTAL VOLUME OF TAX EXEMPT DEBT, THE PRESIDENT'S PROPOSAL ALSO PROHIBITS REFUNDING OF STATE AND LOCAL GOVERNMENT BONDS OF ANY KIND. LOCAL GOVERNMENT SERVICE NEEDS REQUIRE CITIES TO ISSUE BONDS UNDER MARKET CONDITIONS WHICH RESULT IN HIGH DEBT SERVICE COST. ISSUERS ARE ALSO OFTEN FACED WITH RESTRICTIVE COVENANTS OF PREVIOUS BOND ISSUES WHICH PRESENT COSTLY ROADBLOCKS TO FUTURE PROGRAMS. TO SOLVE THE PROBLEMS OF HIGH DEBT SERVICE COSTS AND RESTRICTIVE PROVISIONS, THE ISSUERS OFTEN "ADVANCE REFUND" THE OUTSTANDING BONDS BY ISSUING NEW BOND ISSUE WHICH CARRY LOWER RATES AND/OR LESS RESTRICTIVE TERMS.

UNDER THE PRESIDENT'S PROPOSAL, WHILE INDIVIDUALS, THE FEDERAL GOVERNMENT AND CORPORATIONS WILL BE ALLOWED TO REFUND THEIR DEBT

AS MARKET CONDITIONS DICTATE, STATE AND LOCAL GOVERNMENTS WILL BE FORCED TO LIVE WITH THE VAGUARIES OF INTEREST RATE FLUCTUATIONS.

IN ADDITION, THE PRESIDENT'S PROPOSAL WOULD ENTIRELY ELIMINATE THE DEDUCTION OF THE INTEREST COST OF CARRYING MUNICIPAL BONDS. UNDER CURRENT TAX LAW, COMMERCIAL BANKS ARE ABLE TO DEDUCT 80% OF THESE INTEREST COSTS. COMMERCIAL BANKS MAKE UP A SIGNIFICANT PORTION OF THE MUNICIPAL BOND MARKET, CURRENTLY HOLDING APPROXIMATELY ONE-THIRD OF ALL OUTSTANDING TAX EXEMPT BONDS. THE PRESIDENT'S PROPOSAL WOULD SERIOUSLY DIMINISH THE ATTRACTIVENESS OF STATE AND LOCAL BONDS TO THESE FINANCIAL INSTITUTIONS. THE LOSS OF AS MUCH AS 1/3 OF THE MARKET WILL MEAN SUBSTANTIAL INCREASES IN COST FOR ISSUERS AND TAXPAYERS IN THE FORM OF HIGHER RATES.

FINALLY, THE PROPOSED TAX REVISIONS WOULD REQUIRE NEW FEDERAL REPORTS ON ALL TAX EXEMPT BOND ISSUES--EVEN GENERAL OBLIGATION BOND ISSUES--AND WOULD REMOVE THE TAX EXEMPTION IF REPORTS WERE NOT FILED. CURRENTLY, NO FEDERAL REPORTING IS REQUIRED FROM MUNICIPAL BONDS EXCEPT FOR SOME PRIVATE PURPOSE BONDS. A WHOLE NEW FEDERAL BUREAUCRACY WOULD BE REQUIRED TO MONITOR THIS REQUIREMENT, RESULTING IN SUBSTANTIAL INCREASED COSTS FOR THE REPORTING JURISDICTIONS.

ACCORDING TO THE CITY'S FINANCIAL ADVISORS, GOVERNMENT FINANCE ASSOCIATES, INC., OF PRINCTON, NEW JERSEY, THE ELIMINATION OF PRIVATE PURPOSE BONDS WOULD REDUCE THE SUPPLY OF TAX EXEMPT BONDS

BY APPROXIMATELY TWO-THIRDS. THEY HAVE ALSO CONCLUDED THAT THE CHANGE IN BANK CARRYING COSTS, IN THE MARGINAL TAX RATE, AND THE REPORTING IN ARBITRAGE RESTRICTIONS WOULD RAISE BORROWING COSTS, AND THAT MANY PROJECTS THAT WERE FORMERLY CONSIDERED TO BE PUBLIC PURPOSE WOULD SUFFER SUBSTANTIALLY INCREASED COSTS THROUGH LOSS OF TAX EXEMPTIONS. FURTHER, THE DETERMINATION OF PUBLIC PURPOSE WOULD SHIFT FROM THE STATE AND LOCAL LEVEL TO THE TREASURY DEPARTMENT IN WASHINGTON, D.C.

WHILE THERE ARE NO RELIABLE ESTIMATES OF THE EFFECT OF THESE NATIONAL MARKET FORCES ON THE GENERAL LEVEL OF INTEREST RATES, THE EFFECTS OF INDIVIDUAL PROPOSALS ON THE CITY OF PORTLAND PROGRAMS CAN BE EVALUATED. THE PRIMARY EFFECTS WOULD BE FROM THE "1% RULE" AND THE ARBITRAGE RESTRICTIONS. THE FOLLOWING SUMMARIZES THE CITY'S ANALYSIS OF THE POTENTIAL IMPACTS ON THE FINANCIAL PROGRAMS IN THE CITY SHOULD THESE PROPOSALS BE ENACTED:

- COST OF ALL CONSTRUCTION-RELATED FINANCING WOULD INCREASE AS A RESULT OF THE TEMPORARY PERIOD RESTRICTIONS WHICH LIMIT THE INTEREST EARNINGS ON BOND PROCEEDS TO CONSTRUCTION. FOR EXAMPLE, THE CONSTRUCTION FUND EARNINGS ON THE PERFORMING ARTS CENTER BOND PROCEEDS SUBSTANTIALLY REDUCED THE PRIVATE FUND RAISING REQUIREMENTS.

- PRELIMINARY ANALYSIS INDICATES THAT THE TREASURY DEPARTMENT REGULATIONS WOULD RESTRICT EARNINGS FURTHER

ON SINKING FUNDS AND BOND RESERVES RESULTING IN HIGHER DEBT SERVICE ON ALL REVENUE BONDS.

- TO THE EXTENT THAT PUBLIC FACILITIES AND PROGRAMS BENEFIT OR ARE AVAILABLE TO THE PUBLIC AS A WHOLE, BOND FINANCING WOULD STILL BE TAX EXEMPT. HOWEVER, IF A PROJECTS BENEFITS, IN THE AGGRAGATE, IS ACCRUED BY MORE THAN 1% TO NON-EXEMPT PERSONS OR ENTITIES THE BONDS WOULD BE TAXABLE. IN ADDITION, TO RETAIN THE TAX EXEMPTION, THE FACILITY MUST BE OPERATED BY THE PUBLIC ENTITY, EXCEPT FOR SHORT TERM CONTRACTS. FOR EXAMPLE, IT APPEARS THAT THE CONTRACT FOR THE DISPOSAL OF SEWAGE SLUDGE AT THE CITY'S COLUMBIA BOULEVARD TREATMENT PLANT, WHICH INVOLVED A PRIVATE CONTRACTOR, WOULD MOST LIKELY HAVE INVOLVED TAXABLE FINANCING.

- BANCROFT BONDS ARE USED TO FINANCE LOCAL IMPROVEMENTS RELATED TO SEWERS, STREETS, AND OTHER PUBLIC IMPROVEMENTS. ACCORDING TO OUR FINANCIAL ADVISERS, BECAUSE THE BONDS DIRECTLY BENEFIT INDIVIDUAL PROPERTY OWNERS, THEY WOULD MOST LIKELY BE SUBJECT TO THE 1% RULE AND THEREFORE TAXABLE. MUCH OF THE LOCAL STREET AND SEWER SYSTEM IN THE CITY OF PORTLAND, AND MOST OTHER CITIES, HAS BEEN FINANCED THROUGH BANCROFT BONDING OR SIMILAR MECHANISMS.

- THE CITY'S GOLF COURSES ARE PARTIALLY OPERATED BY PRIVATE CONTRACTORS RESULTING IN SUBSTANTIALLY LOWER COSTS AND HIGHER REVENUES TO THE CITY. SHOULD ADDITIONAL FINANCING FOR THE COURSES BE REQUIRED, THE CITY WOULD BE FORCED TO OPERATE THE COURSES ITSELF OR ACCEPT TAXABLE FINANCING.

- MOST OF THE CITY'S PARKING GARAGES ARE CURRENTLY OPERATED UNDER MANAGEMENT SERVICE CONTRACTS. TO THE EXTENT THAT CONTRACT OPERATIONS ARE CONTINUED AT THESE FACILITIES, THE MANAGEMENT VERSUS TAXABLE FINANCING DILEMMA EXISTS.

- THE CONCESSION CONTRACTS AT THE PORTLAND CIVIC AUDITORIUM AND THE NEWLY OPENED ARLENE SCHNITZER CONCERT HALL MAY BENEFIT NON-EXEMPT INDIVIDUALS OR ENTITIES TO SUCH AN EXTENT THAT FURTHER FINANCING OF THESE FACILITIES WOULD INVOLVE TAXABLE FINANCING. IN ADDITION, THE PRESIDENT'S PROPOSAL MAY PRECLUDE THE USE OF FINANCING MECHANISMS NECESSARY TO COMPLETE THE CENTER.

- IN THE CASE OF TAX INCREMENT FINANCING FOR URBAN RENEWAL PROJECTS, THE PORTION OF BOND PROCEEDS FROM URBAN RENEWAL BOND SALES USED FOR PUBLIC IMPROVEMENTS WOULD BE TAX EXEMPT AS LONG AS THE FACILITIES WERE OPEN TO THE PUBLIC. FACILITIES WHICH SERVE EXCLUSIVE USERS, WOULD NOT. ACCORDINGLY, WHILE THE CITY COULD FINANCE IMPROVEMENTS TO TOM MCCALL WATERFRONT PARK WITH TAX EXEMPT BONDS, THE NORTHWEST FRONT AVENUE PROJECT WHICH WAS CRITICAL TO WACKER SILTRONICS LOCATING IN PORTLAND WOULD HAVE REQUIRED TAXABLE FINANCING. IN ADDITION, TAX INCREMENT BOND PROCEEDS HAVE BEEN USED VERY EFFECTIVELY IN FINANCING HISTORIC PRESERVATION, HOUSING AND URBAN DEVELOPMENT PROJECTS IN PORTLAND. THESE WOULD PROBABLY BE PRIVATE PURPOSES UNDER THE PROPOSAL.

- THE CITY IS JUST BEGINNING TO USE ITS AUTHORITY TO ISSUE INDUSTRIAL REVENUE BONDS FOR ECONOMIC DEVELOPMENT PURPOSES. THIS PROGRAM WOULD BE ELIMINATED UNDER THE PRESIDENT'S PROPOSAL. FURTHER, THE CITY AND STATE HOUSING REVENUE BOND PROGRAMS WOULD LOSE TAX EXEMPTION DUE TO THE 1% RULE.

IN SUMMARY, ACCORDING TO THE CITY'S FINANCIAL ADVISORS, ALL CITY FINANCING PROGRAMS WOULD BE ADVERSELY AFFECTED BY THE PROVISIONS OF THE PRESIDENT'S TAX PROPOSAL WHICH RESTRICTS TAX EXEMPT BORROWING. THESE RESTRICTIONS WILL INCREASE FINANCING COSTS BY REQUIRING TAXABLE FINANCING, WHICH COULD INCREASE BORROWING RATES BY AS MUCH AS 30%. IN SOME CASES, THIS WILL MEAN THE ELIMINATION OF ENTIRE PROGRAMS FOR CAPITAL CONSTRUCTION PROJECTS. IN SHORT, THE LOSS OF TAX EXEMPT STATUS FOR THESE REVENUE MECHANISMS, WOULD BOTH INCREASE THEIR COSTS TO TAXPAYERS AND EFFECT THEIR MARKETABILITY. FEDERAL TAX POLICY HAS COME TO DOMINATE FEDERAL

URBAN POLICY. ACCORDINGLY, THE CHANGES PROPOSED BY THE PRESIDENT WOULD HAVE A PROFOUND IMPACT ON THE ABILITY OF CITIES SUCH AS PORTLAND AND STATES SUCH AS OREGON TO MEET CURRENT AND FUTURE ECONOMIC, SOCIAL, ENVIRONMENTAL AND OTHER COMMUNITY NEEDS.

THE PRESIDENT'S PROPOSAL IS A SWEEPING REVISION OF THE FISCAL COMPONENT OF THE UNITED STATES FEDERAL SYSTEM, RADICALLY CHANGING THE RELATIONSHIP BETWEEN THE FEDERAL GOVERNMENT AND THE CITIES AND STATES, FOR THE PURPOSE OF RAISING FEDERAL TAXES. THE HIGHER TAXES WILL BE PAID INDIRECTLY BY THE LOCAL TAXPAYERS THROUGH HIGHER FINANCING COSTS ON LOCAL FINANCING MECHANISMS, AND DIRECTLY THROUGH THE LOSS OF SUCH MECHANISMS AS THE FEDERAL DEDUCTION FOR STATE AND LOCAL TAXES.

HISTORIC AND REHABILITATION TAX CREDIT

THE CITY OF PORTLAND SUPPORTS THE FEDERAL TAX INCENTIVES CURRENTLY AVAILABLE FOR REHABILITATING HISTORIC BUILDINGS. ENACTED IN 1981, THE INCENTIVES PROVIDE A 25% TAX CREDIT FOR THE REHABILITATION OF COMMERCIAL OR RESIDENTIAL RENTAL HISTORIC BUILDINGS. THROUGHOUT OREGON THE CREDITS HAVE BEEN RESPONSIBLE FOR NEARLY $130 MILLION IN INVESTMENT INVOLVING MORE THAN 80 HISTORIC BUILDINGS. THESE PROJECTS HAVE EMPLOYED HUNDREDS OF OREGONIANS AND CREATED SUBSTANTIAL ADDITIONAL INVESTMENT IN THE COMMUNITIES WHERE THEY HAVE BEEN EMPLOYED.

THE MAJORITY OF THESE PROJECTS HAVE OCCURRED IN PORTLAND.

NATIONALLY, APPROXIMATELY $5 BILLION OF PRIVATE INVESTMENT AND REHABILITATION OF MORE THAN 6,800 HISTORIC BUILDINGS HAS OCCURRED SINCE 1981. THE CREDIT GENERATES ECONOMIC REVITALIZATION IN OLDER DECLINING AREAS, AND HAS BEEN ESTIMATED TO HAVE EMPLOYED MORE THAN 180,000 PEOPLE. IN ADDITION, MORE THAN $5 BILLION HAS BEEN GENERATED IN INCREASED LOCAL RETAIL SALES AND BUSINESS ACTIVITY AND LOCAL ECONOMIES HAVE EXPERIENCED AN ADDITIONAL $4 BILLION IN INCREASED WAGES. MORE THAN 36,000 HOUSING UNITS HAVE BEEN REHABILITATED SINCE JANUARY OF 1982. OF THESE MORE THAN 18,000 RENTAL HOUSING UNITS WERE CREATED BY CONVERTING UNDERUTILIZED AND OFTEN ABANDONED COMMERCIAL, INDUSTRIAL AND EDUCATIONAL BUILDINGS INTO FULL USE. THE PROGRAM IS NARROWLY TARGETED, APPLYING ONLY TO HISTORIC BUILDINGS IN CERTAIN AREAS.

WITHOUT THE PRESERVATION TAX INCENTIVE, MARKET FORCES WILL CHANNEL INVESTMENT AWAY FROM HISTORIC BUILDINGS. RISING PROPERTY VALUES, PRESSURE TO MAXIMIZE DEVELOPMENT POTENTIAL UNDER EXISTING ZONING, AND THE MOVEMENT OF ECONOMIC ACTIVITY AWAY FROM OLDER, CENTRALIZED BUSINESS AREAS WILL LEAD TO THE LOSS OF REHABILITATING THESE HISTORIC STRUCTURES. UNFORTUNATELY, THESE MARKET FORCES DO NOT TAKE INTO ACCOUNT THE PUBLIC BENEFIT OF PRESERVING OUR HERITAGE. WHILE INTANGIBLE, THESE BENEFITS WILL REDOUND TO THE PUBLIC-AT-LARGE FOR GENERATIONS TO COME. WITHOUT TAX ASSISTANCE, THESE BENEFITS WOULD GO UNREALIZED. IN ADDITION, THE EXTRA COSTS OF DOING QUALITY HISTORIC REHABILITATION ARE often unrewarded in the marketplace. Nevertheless, these are important projects which should be supported by the federal government as well as state and local private investors. In this way, the federal government will support a national policy of saving the best of our architectural and historical heritage for the benefit of current and future Americans.

Mr. Chairman, once again, on behalf of Mayor Clark and the members of the Portland City Council, thank you for providing the City of Portland with this opportunity to address our concerns regarding the President's tax proposals to you and the members of your Committee. We look forward to providing you with additional information and analysis on the effect of these proposals on Oregon residents as you consider these provisions, and hope to resolve these issues in the best interests of the citizens of our City and State.

STATEMENT OF ROBERT TAFT, JR.
PARTNER, TAFT, STETTINIUS & HOLLISTER
BEFORE THE U.S. SENATE COMMITTEE ON FINANCE
July 25, 1985

Federal Taxation of Interest on Bonds Issued by States, Municipalities, and Other Political Subdivisions is Barred by the U.S. Constitution

This is the statement of Robert Taft, Jr., a partner in the law firm of Taft, Stettinius & Hollister in Cincinnati, Columbus, and Washington, D.C.

Congress should not approve the Administration's proposal to allow federal taxation of interest earned on state and municipal bonds for the plain reason that the proposal is unconstitutional. In addition, there are significant considerations involving the economy, unemployment, housing, and the fiscal integrity of states and municipalities that also weigh against the Administration's proposal.

United States Supreme Court Chief Justice John Marshall first pronounced the principle for the tax-exempt status of state and municipal bond interest in McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 426-27 (1819). States lacked the power to tax federal instrumentalities according to the Supreme Court. Supreme Court cases since McCulloch have established reciprocal state and federal immunity from taxation of governmental instrumentalities. In Weston v. Charleston, 27 U.S. (2 Pet.) 449, 468 (1829), the Court stated that federal taxation of state borrowing would place a burden on the operations of government with the potential of completely arresting the effectiveness of state government. The Court in Veazie Bank & Fenno, 75 U.S. (8 Wall.) 533, 547 (1869), specifically exempted from the taxing power of Congress all state agencies employed for purposes of the state government. The Supreme Court dealt squarely with the issue of federal taxation of interest on municipal and state bonds in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, aff'd on rehearing, 158 U.S. 601 (1895). In Pollock, the Court stated that the federal government lacked the power under the Constitution to tax state or municipal bonds. The Supreme Court has never overruled the holding in Pollock that the Constitution forbids federal taxation of state and municipal bonds. When the Supreme Court upheld a federal tax on state liquor dealers in South Carolina v. United States, 199 U.S. 437, 463 (1905), the Court specifically preserved state tax immunity for all state bonds and obligations that served public purposes.

The Sixteenth Amendment to the Constitution, ratified in 1913, offered no change to the tax-exempt status of state and municipal bonds. President William Howard Taft proposed the amendment to eliminate the requirements of uniformity and apportionment in taxation so as to allow for a progressive income tax, not to change reciprocal immunity of taxation between the federal and state governments. The sponsor of the amendment in the

Senate, Senator Brown, emphasized that the Constitution prevented federal taxation of state bonds and securities, and that the Sixteenth Amendment would not alter that finding. 45 Cong. Rec. 2245-46 (1910). No member of Congress proposed that the amendment would allow such taxation of state bonds and obligations. Ten years after the ratification of the Sixteenth Amendment, the Federal Trade Commission cited Pollock v. Farmers' Loan & Trust Co. in a report regarding federal taxation of interest income and concluded that the Sixteenth Amendment did not allow federal taxation of interest on state or municipal bonds or obligations. See S. Doc. No. 148, 68th Cong., 1st Sess. (1923).

Since the ratification of the Sixteenth Amendment, the Supreme Court has consistently recognized the constitutional exemption from federal taxation of state and municipal bonds and obligations. In Macallen Co. v. Massachusetts, 279 U.S. 620, 628, rehearing denied, 280 U.S. 513 (1929), the Court stated that "for one government--state or national--to lay a tax upon the instrumentalities or securities of the other is derogatory to the latter's dignity, subversive of its powers and repugnant to its paramount authority." The Court in Willcuts v. Bunn, 282 U.S. 216, 226 (1931) cited Pollock v. Farmers' Loan & Trust Co., supra, and acknowledged that interest on state obligations is exempt from federal taxation because such taxation would bear directly upon the borrowing power of the states. In Helvering v. Gerhardt, 304 U.S. 405, 417 (1938), the Court held that the federal government could tax the salaries of municipal employees, but specifically noted that taxation immunity applied to income from the investments in bonds of municipalities, or income received by a private investor from state bonds.

Under the reciprocal immunity doctrine, federal bonds, stocks, certificates of indebtedness, or other obligations issued by the United States enjoy immunity from state taxation. Montana Bankers Ass'n v. Montana Dept. of Revenue, 580 P.2d 909, 177 Mont. 112 (1978); A. Carlotti & Co. v. Norberg, 437 A.2d 119 (R.I. 1981). A state tax, however small, upon federal securities or the interest derived therefrom, interferes with the constitutional borrowing power of the United States. Macallen Co. v. Commonwealth of Massachusetts, 279 U.S. 620, 49 S.Ct. 432, rehearing denied, 280 U.S. 513, 50 S.Ct. 14 (1929); Montana Bankers Ass'n v Montana Dept. of Revenue, 580 P.2d 909, 177 Mont. 112 (1978). By the same token, a federal tax upon state securities or the interest derived therefrom interferes with the borrowing power of the state. Helvering v. Gerhardt, 304 U.S. 405, 417 (1938); Willcuts v. Bunn, 282 U.S. 216, 226 (1931); Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, 584, aff'd on rehearing, 158 U.S. 601 (1895).

When the United States Supreme Court held that the federal government could tax the salaries of state employees in Helvering v. Gerhardt, supra, the question remained as to whether a state could tax the salaries of federal employees. The Court applied reciprocal treatment in Graves v. New York ex rel O'Keefe, 306 U.S. 405 (1939), holding that states could tax the salaries of federal employees. Id. at 486. In both cases, the court stated that the effect of the tax was so remote or uncertain that it did not impose an unacceptable burden on the affected government. See id. at 485-86; See also Gerhardt, 304 U.S. at 422-23. If the U.S. Supreme Court or the Congress determined that a tax upon government securities and obligations or the interest derived therefrom did not impose an intolerable burden on government and thus permitted taxation of state instrumentalities, then the federal government might be confronted with the reciprocal taxation of federal securities and instrumentalities by the states. See Graves v. New York ex rel O'Keefe, supra.

The federal government has greater power than the states to prevent reciprocal taxation. The federal government may withdraw itself from the risk of reciprocal taxation through acts of Congress. Such acts afford the federal government protection from state taxation, while reciprocal state legislation would fail to similarly restrict federal taxation of the states because of the "supremacy" and "commerce" clauses of the United States Constitution. See McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819). Because of this potential imbalance, and because the power to tax includes the "power to destroy", Id. at 431, the United States Supreme Court has stated that the federal government may not constitutionally infringe upon the borrowing power of the states through taxation on the interest earned from state or municipal bonds. Macallen Co. v. Massachusetts, 279 U.S. 620, 49 S.Ct. 432, rehearing denied, 280 U.S. 513, 50 S.Ct. 14 (1929); Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429, aff'd on rehearing, 158 U.S. 601 (1895).

In the process of upholding the exemption from federal taxation of interest on state and municipal obligations, the Supreme Court in the past has required that such obligations serve traditional and public purposes of state government. However, in Garcia v. San Antonio Metropolitan Transit Authority, ____ U.S.____, 105 S.Ct. 1005, 1015 (1985), the Court rejected the "public purpose" test and acknowledged that functions once considered private and outside the realm of government may evolve into government functions:

> The essence of our federal system is that within the realm of authority left open to them under the Constitution, the States must be equally free to engage in any activity that their citizens choose for the common need, no matter how unorthodox or unnecessary anyone else--including the judiciary--deems state involvement to be. . . . 'The science of government. . .is the science of experiment,' Anderson v. Dunn, 6 Wheat. 204, 226 (1821), and the States cannot serve as laboratories for social and economic experiment, see New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting), if they must pay an added price when they meet the changing needs of their citizenry by taking up functions that an earlier day and a different society left in private hands.

105 S.Ct. at 1015.

The Tenth Amendment states that "[t]he powers not delegated to the United States by the Constitution, not prohibited by it to the States, are reserved to the States, respectively, or to the people." Garcia reaffirms the Tenth Amendment by deferring to state authority where the constitution has not transferred such authority to the federal government. 105 S.Ct. at 1017. The Garcia Court noted that the Constitution recognizes and preserves the independence and autonomy of state legislative and judicial departments. Id.

The United States Supreme Court has stated that federal taxation of interest earned on state or municipal bonds is unconstitutional, Pollock v. Farmers' Loan & Trust Co., supra, is subversive to a state's powers and authority, Macallen Co. v. Massachusetts, 279 U.S. 620, 49 S.Ct. 482, rehearing denied, 280 U.S. 5I3, 50 S. Ct. 14 (1929), and would impair the borrowing power of the state, Helvering v. Gerhardt, 804 U.S. 405 (1938). Further, the Court has held that the scope of government purposes and functions shall be determined by the legislature, not by the judiciary through a "public purpose" test. Garcia v. San Antonio Metropolitan Transit Authority, 105 S.Ct 1005, 1015 (1985). Finally, the Court has stated that state sovereignty remains effective in areas not delegated in the Constitution to the federal government (such as state borrowing authority). Id.

The most important reason to reject the proposal to tax interest on the bonds of states, municipalities, and other political subdivisions, is that the proposal is unconstitutional, and could be thrown out by the Supreme Court. However, the reasons for retaining reciprocal immunity of government security taxation go beyond the constitutional requirement of preserving the independence of the state and federal governments. The additional reasons concern the purposes and benefits derived from bonds issued by states, municipalities and other political subdivisions.

State and municipal bonds serve as important catalysts in both urban and rural areas for providing jobs, industrial and business development, housing, and other services. The principal reason state and municipal bonds are attractive to investors is the tax-exempt status of the bonds. The tax exemption thus provides an essential element in the borrowing power of states, municipalities, and other political subdivisions.

Industrial development bonds assist states throughout the country. In depressed or underdeveloped areas, industrial development bonds play an essential role in attracting industry, providing jobs, and securing economic health for such areas. In the older urban and developed regions of the Midwest and Northeast, industrial development bonds not only serve to attract new industry to communities still recovering from recession and outmigration, but also allow troubled industries and businesses to modernize and remain competitive regionally, nationally, and internationally, instead of closing down and removing jobs to another region of the United States, or to another country entirely. According to a study released in June, 1985, by the Government Finance Research Center of the Government Finance Officers Association, cities across the United States use industrial development bonds more often than any other form of economic incentive to promote growth and development. The industrial development bonds issued by states, municipalities and other political subdivisions play a crucial role in urban development at a time when federal assistance to cities is declining.

Congress has stated that the general welfare and security of the United States requires community development sufficient to eliminate blighted areas and the production of decent housing for all Americans. See Housing Act of 1949, Pub. L. No. 81-171, 63

Stat. 413 (codified as amended at 42 U.S.C. §1441 (1980)). Certain bonds issued by states, municipalities, or other political subdivisions currently support the construction of single and multi-family housing for low-to-moderate income families, or the elderly. The Joint Center for Housing Studies of the Massachusetts Institute of Technology and Harvard University and Wharton Econometrics Forecasting Associates, Inc., issued a report in July, 1985, which estimated that the Administration's tax plan would halt the construction of nearly 100,000 rental apartments now being built each year with tax-exempt financing. Annual single-family housing starts would decline by an average of 30,000 units, according to the study. The Wharton/Harvard Study estimated that rents for apartments financed with currently tax-exempt bonds would increase by nearly 60% as a result of the Administration's tax plan. The study indicated that developers who would currently expect an 8% rate of return on their investments in apartments would instead receive a return of about 1%. The Wharton/Harvard Study concluded that under the proposed tax plan, developers would not choose to construct low-to-moderate income housing and housing costs for low-to-moderate income families would increase.

Elimination of tax-exempt financing for states and municipalities would stunt economic development and the creation of new jobs, as well as curtail important services such as providing affordable housing. But the elimination of tax-exempt financing also would place states and municipalities in an intolerable fiscal squeeze. The Public Securities Association has estimated that elimination of the tax-exemption for state and municipal securities as proposed by the drafted legislation would increase state and local borrowing costs by approximately $39 billion over the next five years. In a statement issued in May, 1985, the Public Securities Association noted that the increased borrowing costs would result in either the deterioration of public services which the federal government has encouraged state and local governments to undertake, or an increase in state and local income, sales and property taxes.

In conclusion, the retention of immunity from taxation of interest on state and municipal bonds is mandated by the Constitution and fiscal common sense. Rather than striking at state borrowing power, Congress should preserve the balance between the state and federal governments, and the ability of states to respond to social and economic needs.